Supreme Court, U. S.
FILED
JUL 30 1979
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

No. 79- 79-153

POTOMAC ELECTRIC POWER COMPANY,
Petitioner,

v.

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA,
PEOPLE'S COUNSEL OF THE DISTRICT OF COLUMBIA,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE DISTRICT OF COLUMBIA COURT OF APPEALS

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CERTIFICATE OF SERVICE

I hereby certify that I have this 30th day of July, 1979 served a copy of this Petition for a Writ of Certiorari to the District of Columbia Court of Appeals, by mailing three copies thereof, together with a copy of this certificate of service, postage prepaid, to counsel for all parties of record, as follows:

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PEOPLE'S COUNSEL OF THE DISTRICT OF COLUMBIA,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE DISTRICT OF COLUMBIA COURT OF APPEALS

Petitioner, Potomac Electric Power Company (Pepco), respectfully prays that a writ of certiorari issue to review the opinion and judgment of the District of Columbia Court of Appeals in Docket No. 10490 entered *en banc* on May 1, 1979 affirming a decision of the Public Service Commission of the District of Columbia (Commission) issued November 12, 1975 and vacating the opinion and judgment of a three-judge panel of that Court entered on November 9, 1977 which had reversed and remanded the decision of the Commission.

OPINIONS BELOW

The *en banc* opinion of the District of Columbia Court of Appeals is reported at 402 A.2d 14 (D.C.

1979) and is reprinted *infra* at Appendix D. That opinion vacated the opinion and judgment of a three-judge panel of the Court reported at 380 A.2d 126 (D.C. 1977) and reprinted *infra* at Appendix C, which reversed and remanded an opinion and order of the Public Service Commission of the District of Columbia. The opinion and order of the Commission is reported at 11 P.U.R. 4th 215 (P.S.C. D.C. 1975) and is reprinted *infra* at Appendix A. The Commission's unreported order denying Pepco's Application for Reconsideration is reprinted *infra* at Appendix B.

JURISDICTION

The judgment of the District of Columbia Court of Appeals was entered on May 1, 1979. This petition for a writ of certiorari was filed within ninety days of that date. The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(3) (1976).

QUESTION PRESENTED

By guaranteeing that Pepco can have no opportunity to earn its authorized rate of return in the District of Columbia, which the Commission itself specifically found was necessary to attract capital, has the Commission confiscated Pepco's property without substantive due process of law and without just compensation in violation of the Fifth Amendment to the United States Constitution?

CONSTITUTIONAL PROVISIONS INVOLVED

The due process and just compensation clauses of the Fifth Amendment to the Constitution of the United States:

> No person . . . shall be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

STATEMENT OF THE CASE

This case concerns the Constitutional obligation of a regulatory commission, in the context of a financially deteriorating industry, to permit a utility a reasonable opportunity to earn the rate of return which the commission itself has found to be just and reasonable and necessary to attract capital in order to provide the electricity demanded by the community it serves.

A. Proceedings Before the Commission

Pepco is engaged in the generation, transmission, distribution and sale of electric energy in the Washington, D.C. metropolitan area, and is subject to the regulatory jurisdiction of the Public Service Commission of the District of Columbia (Commission), the Maryland Public Service Commission, and the Virginia State Corporation Commission with respect to retail rates. Pepco also is regulated by the Federal Energy Regulatory Commission (FERC) in connection with its wholesale electric sales.

On December 20, 1974, Pepco filed an application with the Commission for an increase in its retail rates for the sale of electricity in the District of Columbia, designed to increase annual revenue in the District by some $50 million, based on the Company's costs of providing service in the District of Columbia in 1974.

Prior to the start of the hearings on its application, Pepco twice sought emergency interim increases in its rates in an effort to stem the further severe deteriora-

tion in the Company's financial condition which was taking place while its permanent rate application was awaiting hearings before the Commission. In each instance, the Commission summarily denied Pepco's application.

Hearings were ultimately held from June 4 through July 24, 1975 and, on July 18, 1975, Pepco filed with its rebuttal testimony updated data reflecting actual operating results during the twelve months ended June 30, 1975. Due to the continuing deterioration of Pepco's operating results in the District, the updated data demonstrated an increased revenue requirement of some $57 million, rather than the $50 million originally requested. This updated presentation clearly showed that Pepco had experienced continuing attrition in earnings since its original rate application was filed.[1]

On November 12, 1975, the Commission by a two-to-one vote issued its opinion and order which authorized an increase of $27.7 million in Pepco's gross operating revenue based upon the Company's 1974 cost of service data, rather than the more current 1975 data submitted by Pepco. Had the Commission applied the precise rate-

[1] Broadly speaking, attrition is defined as the inability of a utility to earn the levels of return found by the regulatory commission to be required to maintain financial integrity and to attract capital on reasonable terms. *See e.g. Telphone Users Ass'n* v. *Public Serv. Comm'n,* 304 A.2d 293, 298 (D.C. 1973), *cert. denied* 415 U.S. 933 (1974). In the practical ratemaking context, attrition generally is caused by inflationary pressures causing rate base investment, expenses, or these two elements of the ratemaking formula in combination, to increase at a rate which outstrips the rate of increase in revenue.

making formula which it approved in this case to the more current data submitted by Pepco, Pepco would have been authorized to increase its rates by *$48 million,* rather than by the $27.7 million computed by the Commission in reliance upon plainly outdated 1974 information. The Commission made no use of the more current data available to it in setting rates which would become effective in 1976.

Commissioner Stratton issued a lengthy dissenting opinion, focusing principally on the majority's failure to set rates at a level which would be sufficient to permit Pepco a reasonable opportunity to earn the rate of return on its investment during the period when the new rates would be in effect (in 1976), a level of return on investment which the Commission itself found in the same order to be required to attract necessary capital. (Appendix A at 44a)

On December 12, 1975, Pepco filed an Application for Reconsideration of the Commission's final decision which was denied by the Commission on January 12, 1976.

B. The Proceedings in the Court Below

On appeal, a three-judge panel of the District of Columbia Court of Appeals, after examining the end result of the Commission's opinion and order in conformity with *FPC* v. *Hope Natural Gas Co.,* 320 U.S. 591, 602-3 (1944) concluded on November 9, 1977 that there was a "clear showing" of a due process violation. Adhering to the standards of review enunciated by this Court in the *Permian Basin Area Rate Cases,* 390 U.S. 747, 791-92 (1968), the panel of the Court of Appeals found the end result of the Commission's deci-

sion unreasonable in overall effect and in specific elements:

> This court has adhered to the standards of review thus enunciated on several occasions. In the instant case, we have examined the overall effect of the Commission's opinion, and find it to be unjust and unreasonable in that it deprived Pepco of the opportunity to earn a fair rate of return by improperly disregarding the latest relevant historical data of record pertaining to the company's operations. Examination of the elements of the opinion reveals several findings and conclusions . . . which are unreasonable, arbitrary, or capricious. These include the Commission's refusal to utilize the most recent test period in the record, its failure to account for continuing attrition, and its refusal to recognize certain known changes which occurred after the originally proposed calendar 1974 test period. (Appendix C at 8c-9c)

The panel of the Court of Appeals further concluded that,

> [B]y arbitrarily disregarding actual, historical and uncontroverted data submitted as evidence by Pepco during the course of the hearing, the Commission all but guaranteed that the company would not be able to approach earning the rate of return it authorized. (Appendix C at 10c)

After hearing reargument *en banc,* the Court of Appeals, with the majority of the panel which originally heard the case dissenting, vacated the opinion of the panel and affirmed the opinion of the Commission on May 1, 1979.

REASONS FOR GRANTING THE WRIT

A reviewing court has the obligation to assess the "end result" of the Commission's final rate order.

FPC v. *Hope Natural Gas Co.,* 320 U.S. 591 (1944). This Court stated in *Hope.*

> Under the statutory standard of "just and reasonable" it is the result reached not the method employed which is controlling. . . . It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end. *Id.* at 602.

This Court in the *Permian Basin Area Rate Cases,* 390 U.S. 747, 791-92 (1968), set forth explicit responsibilities of a reviewing court with respect to a utility commission order:

> First it must determine whether the Commission's order viewed in light of the relevant facts and of the Commission's broad regulatory duties, abuses or exceeded its authority. Second, the court must examine the manner in which the Commission has employed the methods of regulation which it has itself selected, and must decide whether each of the order's essential elements is supported by substantial evidence. Third, the court must determine whether the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and forseeable.

The Court of Appeals fell far short of meeting its responsibilities as mandated in *Hope* and *Permian Basin.* The result is that this Court's opinions are being severely eroded. The Court of Appeals totally failed to meet its obligation to assess the consequences of the Commission's order. In fact, the Court of Appeals' *en banc* opinion never even addressed the issue

which was raised by Pepco and which formed the focus of the panel's earlier decision, that the Commission had violated Pepco's constitutional rights by setting rates at a level that denied it any opportunity to earn the authorized fair rate of return during the period the new rates were to be in effect.

I

The Commission's Unreasonable Refusal To Consider The Most Current Data Presented In The Record Or To Otherwise Deal With The Demonstrated Severe Attrition In Pepco's Earnings Guaranteed That Pepco Could Have No Opportunity To Earn Its Authorized Rate Of Return And Thereby Confiscated Pepco's Property Without Substantive Due Process And Without Just Compensation

The standard of the Public Service Commission Law with respect to ratemaking in general is that rates established must be just and reasonable (43 D.C. Code Ann. §§ 301, 401, 411 (1973)). This standard is the same in all respects as that embodied in the Natural Gas Act and the Federal Power Act.[2] In order to give effect to this standard of just and reasonable rates, the Commission must balance the interest of consumers with the interest of investors. It is the "end result" which must be reasonable. *Hope, supra; Permian Basin, supra.*

Utility ratemaking traditionally uses an historical test period adjusted for known changes to provide a representative basis for the setting of rates for prospective electric service. But an historical test period is a proper ratemaking tool only when it can be used to

[2] 15 U.S.C. §§ 717(c) and (d) (1976); 16 U.S.C. §§ 824(d) and (e) (1976); *Washington Gas Light* v. *Baker,* 188 F.2d 11, 14 (D.C. Cir. 1950), *cert. denied,* 340 U.S. 952 (1951).

forecast with reasonable accuracy the *future* relationship among revenue, expenses, rate base investment, and rate of return, thereby providing a proper basis for *future* rates.

As recounted in detail in the three-judge panel's decision below, the record before the Commission showed that the originally proposed calendar 1974 test period had become irrelevant as a predictive tool for setting rates for the future by the time hearings were commenced, much less concluded. The revenue, expense and rate base relationships had changed drastically during the period between December 31, 1974 and June 30, 1975 because of substantial increases in rate base and all other costs of providing service.

To reflect the changed conditions, Pepco assembled actual results of operation for the twelve months ended June 30, 1975. Pepco's undated test period data were filed with the presentation of its rebuttal case. The 1975 financial data were introduced and received into evidence at the hearings before the full Commission without objection by any party. The presentation clearly showed a serious attrition problem facing Pepco in 1975.[3]

[3] Pepco was faced with a rapidly deteriorating financial situation with return on common stock equity in the District dropping to 6.09% as compared with the authorized return of 13% and average yield of over 10% on A-rated utility bonds. Earnings per share of common stock had declined to $1.14, below the annual dividend level, and interest coverage was only 1.89 times, thereby jeopardizing Pepco's bond ratings. Pepco could not legally issue preferred stock because it could not meet the charter coverage. The ability to sell common stock was severely limited because it value hovered at par value, the legal limit below which is cannot be issued. As a result, Pepco was foreclosed from financing its minimum construction program with permanent capital.

Nevertheless, the Commission refused to make use of the most recent available test period on the record before it and based its revenue determination on the stale 1974 test period.

The effect of this unreasonable refusal to make use of the more current data presented by Pepco was extremely substantial. Had the Commission applied the precise ratemaking formula which it had approved in this case to the actual 1975 data in the record, the result would have been a $48 million rate increase, instead of the $27.7 million granted on the basis of the stale 1974 data.

The Commission even refused unaccountably to adjust the unrepresentative 1974 data to reflect known 1975 changes in costs, revenue, and investment, all of which were properly in evidence, and were much more representative of conditions prevailing when the new rates were finally placed into effect.

The Court of Appeals *en banc* merely dismissed the failure to use the updated test year as a matter of "discretion." It observed that the Commission should "select a test year that appears likely to be representative of the future" (Appendix D, at 10d), never looking to see if the Commission had, in fact, done so, when in fact the uncontroverted evidence of actual 1975 conditions proved conclusively that the 1974 data were outdated.

Calling this "the majority's 'hear no evil, see no evil' approach to this case," dissenting Judge Harris observed that "it would be difficult for me to conceive of a rate case in which the agency's action could more readily be seen to be erroneous than this case." (Appendix D at 29d) The majority opinion brushed the

dissent aside as not worthy of rebuttal due to its "unfortunate tone." (Appendix D at 28d)

The fact is that the more current data was in the record, available to the Commission, and demonstrated on its face the inaccuracy of "predictive" rates based on the older, stale data. This was not only apparent, but argued vehemently by Pepco below. The precedents of this Court required the Commission to base its decision directly on the updated data, or instead to reflect the updated data in adjustments to the earlier test period and the ultimate end result of the order. The unconstitutional deficiency was to fail to do either.

The Commission's refusal to make use of the most recent available data on the record before it was in conflict with the fundamental ratemaking principle that test periods must be representative of the period during which the rates will be in effect, as discussed *infra*. The *en banc* Court of Appeals' error was to fail to look critically at the relationship between the evidence cited by, and the "end result" announced by, the Commission, sweeping aside its three-judge panel's careful analysis in the process, and holding that the Commission had unbridled discretion in the matter.

This case is extraordinary in that the District of Columbia Court of Appeals in this, its first major public utility rate case, has ignored the fundamental legal principles of ratemaking and this Court's decisions with respect to ratemaking in such a way as to compel the dissenters to echo this lament of Commissioner Stratton, the dissenter on the three-member Commission:

> "In failing to acknowledge and deal with the fact that operating and capital requirements per unit

of sales have risen, and continue to rise, faster than revenues, the Commission has taken a step that can only bring regulation in the District of Columbia into disrepute among the fair-minded and knowledgeable." (Appendix D at 38d)

The dissenting Commissioner below noted,

> For, if ever a record demonstrated attrition, this one does. If ever a record called for realistic steps to deal with attrition, this one does. If there was ever a demonstration of the failure of revenue growth to keep up with the growth of expenses and investment, it appears in the record spread before the Commission in this case, where there is data not only for the test year but also for the nine months following—data which the Commission accepted into the record, I had thought, for the purpose of reaching a decision that took account of the real world as it was revealed to us by the operating results of the company during the pendency of the case. (Appendix A at 65a-66a)

The fact remains that the Commission's failure to use the most current data in the record in combination with its refusal to make adequate allowance for attrition in the face of a "declining trend" in earnings guaranteed that Pepco could not conceivably ever approach the *authorized* rate of return the Commission itself specifically found to be required to attract capital. That ratemaking approach directly contravenes the due process and just compensation clauses of the Fifth Amendment. *FPC* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 585 (1942).

Indeed, this Court has already recognized the evils of stale test year data in regulation of essential utility services:

> We think the adoption of a single year as an exclusive test or standard imposed upon the company an arbitrary restriction in contravention of the Fourteenth Amendment and of 'the rudiments of fair play' made necessary thereby. [Citation omitted] The earnings of the later years were exhibited in the record and told their own tale as to the possibilities of profit. *To shut one's eyes to them altogether, to exclude them from the reckoning, is as much arbitrary action as to build a schedule upon guesswork with evidence available. West Ohio Gas Co.* v. *Public Util. Comm'n of Ohio,* 294 U.S. 79, 81-82 (1935) (emphasis supplied).

The Court of Appeals itself has asserted the same principle in another case even so recently as this year. *People's Counsel* v. *Public Serv. Comm'n,* 399 A.2d 43, 51 n.14 (D.C. 1979):

> A test year must be representative of future conditions. The Commission is required to make appropriate adjustments to test year results that are unrepresentative to account for changed conditions not reflected in test year data. *City of Evansville* v. *Southern Indiana Gas & Elec. Co.,* 339 N.E. 2d 562, 575 (Ind. Ct. App. 1975).

Pepco introduced all the relevent evidence in its possession and requested the Commission to consider the evidence of overwhelming and continuing attrition and provide a solution which offered Pepco a reasonable opportunity to earn the rate of return the Commission itself held was necessary to attract capital—whether through use of the updated test period, use of a *full* end-of-period rate base investment amount, au-

thorization of a specific dollar attrition, recognition of the current factual situation when weighing adjustments to the stale 1974 test period, or adoption of a combination of remedies. All such remedies were denied —even though the Commission specifically found that "attrition is still with us."

II

Arbitrary Utility Rate Regulation And Partisan Rate Case Review By The State Courts Are Inimical To The National Economy And To The Country's Ability To Cope With the National Energy Crisis

This case is not an isolated aberration. In the District of Columbia, it is one of three Pepco cases decided and finally announced by the Court of Appeals within a one-week period, all dealing with various aspects of utility ratemaking and all guaranteeing that the utility has *no* opportunity to earn the rate of return specifically found by the regulatory body to be *required* to attract necessary capital.[4] It is the manifestation in the District of Columbia of a pervasive non-federal regulatory and judicial attitude towards utility rates which the Court's dissenters condemned as follows:

> One result of the majority's resolution of this appeal seems regrettably inescapable: The Commission will conclude that virtually any treatment of a utility which purports to be "pro-consumer" in

[4] *Washington Public Interest Organization* v. *Public Serv. Comm'n*, 393 A.2d 71 (D.C. 1978), *reh. en banc denied*, Docket No. 12017 (May 3, 1979); *Potomac Electric Power Co.* v. *Public Serv. Comm'n*, —— A.2d —— (Docket No. 10909, D.C. March 16, 1979), *reh. en banc denied* (May 8, 1979), each of which is the subject of petitions for writs of certiorari concurrently filed herewith.

> nature is likely to escape perceptive judicial review. (Appendix D at 29d)
>
> * * * *
>
> If the Commission arbitrarily refuses to achieve the requisite delicate balance between consumer and investor interests, it is not only violating the utility's constitutional rights, it is grievously harming the true long-range interest of consumers as well. . . . That is precisely what occurred in this case. (Appendix D at 37a-38d)

It is common knowledge that since the early 1970's, electric utility efficiencies of scale have been overshadowed by inflation, mounting environmental restrictions, greater expense for scarce land, and sharply rising fuel costs. Due to the limited nature of federal rate regulation of electric utilities,[5] almost all resulting major electric rate increases have been debated, decided and reviewed at the state level.

Federal regulation in the energy field (such as conferred by the Natural Gas Act, 15 U.S.C. §§ 717 *et seq.* (1976), on the Federal Energy Regulatory Commission) is the subject of extensive political commentary and attention, and has brought on significant appellate responsibilities. This Court has acknowledged its responsibility not only to ensure a "flexible" regulatory framework, but also adequate judicial oversight of the

[5] The Federal Power Act, 16 U.S.C. §§ 791, *et seq.* (1976), confers jurisdiction in the Federal Energy Regulatory Commission (FERC) over *wholesale* transactions in interstate commerce. The rates paid by retail customers, and all jurisdiction over the expansion of generation facilities required to serve them, are regulated solely by the states. FERC jurisdiction is thus limited to perhaps only 10% of all sales of electricity.

constitutional boundaries to that "flexible" regulation. *Natural Gas Pipeline, supra,* at 586; *Permian Basin, supra,* at 792.

The imperatives are no less significant in the regulation of electric utilities. The financial health of the industry has deteriorated to precarious levels and the states are experimenting with flexible, sometimes innovative, and sometimes unconstitutional regulatory schemes and practices. Each state's decision is not "unique", even if viewed in isolation; the themes recur. Pepco submits that this Court should signal at this critical point that it has not abandoned its oversight of constiutional safeguards in the operation of perhaps the most crucial component of our private economy, particularly in these times of energy crisis and rampant inflation.

Pepco submits that the standards of regulation and regulatory oversight embodied in this case below are as clearly deficient as any this Court will be presented in the future. The issues have been thoroughly and forcefully explored below, particularly in the dissent to the Commission's opinion (Appendix A), the opinion and concurring opinion of the three-judge panel of the Court of Appeals (Appendix C at 1c-83c), and in the dissent to that Court's *en banc* opinion. (Appendix D at 29d-38d)

CONCLUSION

The Commission's order, viewed in its entirety, produced an arbitrary result that deprived Pepco of its property without due process or just compensation. The Commission first established the rate of return it specifically found to be necessary to attract capital and then, by using its arbitrary refusal to consider current operating data, absolutely guaranteed that Pepco could have no opportunity to earn it. The *en banc* opinion of the Court of Appeals has perpetuated that unconstitutional result. For the foregoing reasons, Pepco urges this Court to grant this petition for a writ of certiorari to the District of Columbia Court of Appeals, that this Court reverse the *en banc* decision of the Court of Appeals and that this Court reinstate the three-judge panel's decision which reversed and remanded the orders of the Commission.

Respectfully submitted,

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APPENDIX

Appendix A

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA

1625 I Street, N.W., Washington, D. C. 20006

Order No. 5739

November 12, 1975

IN THE MATTER OF

Application of POTOMAC ELECTRIC POWER COMPANY for an increase in its retail rates for the sale of electric energy	))))	Formal Case No. 630

FINAL OPINION AND ORDER

BEFORE THE COMMISSION: Ruth Hankins-Nesbitt, Chairperson; H. Mason Neely, Vice Chairman; and William R. Stratton, Commissioner

Procedural History

This case had its genesis in the December 20, 1974 application by Potomac Electric Power Company (PEPCO) for increased rates annually for retail electric service amounting to $48,243,000 and subsequently increased to $50,832,000 in the District of Columbia. On January 9, 1975, the Commission gave public notice of the filing and content of the PEPCO application and of the scheduling of a February 19, 1975 prehearing conference. This prehearing conference, rescheduled for February 20, 1975 by

Commission notice dated January 27, 1975, was then rescheduled for March 7, 1975 (Commission Notice, February 18, 1975), and again rescheduled for and held on May 6, 1975.

By Supplemental Notice of Prehearing dated April 18, 1975, the Commission urged parties having common interests to endeavor to arrange consolidated presentations, and directed all parties to prepare and file with the Commission prior to the prehearing a statement of issues proposed to be addressed, the number of witnesses and the subject matter of their testimony, and a proposed procedural schedule.

By Order No. 5718, May 20, 1975, the Commission granted intervention to some thirteen parties: The Office of People's Counsel; Department of Highways and Traffic, District of Columbia Government; All-Electric Customers of the District of Columbia (AC/DC); Apartment and Office Building Association of Metropolitan Washington, Inc.; Consumers Urging Rate Equity; D.C. Power; Friendship House; General Services Administration; League of Women Voters; All Souls Church; Washington Public Interest Organization and Dr. and Mrs. Henry Kalmus. The Commission also announced in Order No. 5718 its acceptance of the issues designated by the parties as relevant and material to the ultimate issue of just and reasonable rates; and fixed procedural dates for the entire case, beginning with a hearing on June 4, 1975 and concluding with oral argument on September 3, 1975. By Public Notice dated June 2, 1975, two additional hearings were scheduled to obtain citizen expression. Although minor adjustments in hearing dates were found necessary and were made, hearings in this case were concluded on schedule.

During the pendency of its basic application, PEPCO twice sought interim rate increases (by applications dated March 12, 1975 and July 3, 1975). Both applications were dismissed by the Commission (Order No. 5707, April 7, 1975; Order No. 5725, July 11, 1975).

Also during the pendency of this proceeding, two other formal cases were consolidated with this case. By Order No. 5703, March 25, 1975 PEPCO's application for approval of an environmental surcharge (Formal Case No. 629) was denied and the issue added to this case. By Order No. 5714, May 5, 1975, the Commission dismissed a compliant against PEPCO by the D.C. Government insofar as it sought reconsideration of prior orders or reparations for past overcharges, but consolidated with this case issues raised by the complaint with respect to the lawfulness of existing PEPCO rates.

The Commission held 22 days of hearings in this case, which produced a transcript of 2,923 pages; and in addition received from the parties 130 exhibits. Briefs were filed by: The Office of People's Counsel; Department of Highways and Traffic, District of Columbia Government; All-Electric Customers of the District of Columbia (AC/DC); Apartment and Office Building Association of Metropolitan Washington, Inc.; Consumers Urging Rate Equity; D.C. Power; Friendship House; General Services Administration; League of Women Voters; All Souls Church; Washington Public Interest Organization and Dr. and Mrs. Henry Kalmus.

The Case In General

At the outset, we must observe that this decision will be the fourth decision by this Commission in the past six years on rate increase applications by PEPCO. We make this observation not by way of criticism of either PEPCO or our regulatory predecessors, but rather as an expression of our deep concern that the time, effort and expense involved in the 1970, 1972, and 1973 PEPCO cases appears to have been ineffectual in solving the economic problems of this utility. We are faced again in this case, as was the Commission in the 1973 PEPCO case, with the assertion by PEPCO that no matter what rate of return the Commission allows, PEPCO will not be able to earn it unless

the Commission includes an inflation allowance in the rate of return, adopts an end of period rate base, includes all claimed items of investment and expense, approves a new fuel clause, adds a separate allowance for attrition, or selects some combination of several of these items.

We are aware of the well settled principle of utility regulation that it is the end result of the regulatory process that must meet the test of justness and reasonableness. We are also aware of the corollary to that principle, that we are not bound to follow any particular methodology in reaching our ultimate conclusion. And while we are desirous in the interest of both sound regulation and a financially sound utility of avoiding the almost annual PEPCO rate increase application, a desire that might suggest radical departure from historical regulatory principles and methodologies, we are not convinced that experimentation in these uncertain economic times would be in the best interest of the ratepayers in the District of Columbia.

In this context, we must and do recognize, as do all parties in this proceeding, the presence of unusual circumstances in the year 1974. More specifically, as the record shows, PEPCO's operating results and earnings picture in early 1974 approached quite closely the picture drawn by this Commission in its 1973 PEPCO case order. In fact PEPCO's own financial data indicates that for the 12 months ended July 1974 it achieved earnings per share of $1.86, a ratio of earnings to fixed charges of 2.74 times, and a return on average common stock equity of 12.2 percent. The Commission's 1973 order found 12.5 percent to be a reasonable return on equity.

The latter part of 1974, however, witnessed a sharp and steady decline in the PEPCO financial results. Viewing the record as a whole, two factors stand out as perhaps the principal causes of this decline: (1) energy conservation resulted in a substantial decrease in the number of kilowatt

hours sold at retail by PEPCO in 1974; and (2) a substantial decrease in the energy and capacity sold by PEPCO to the Pennsylvania, New Jersey, Maryland (PJM) Pool, of which PEPCO is a member. Had these two dramatic changes not occurred, the need for a rate increase application by PEPCO may very well have been eliminated. Together, the two changes represented an order of magnitude decrease in PEPCO's gross revenue of some $65,000,000.

We see no evidence of record which persuades us that there will be a return to past normalcy in the near term future in either or both of these items. Although 1975 operating data, of which we may take official notice, indicates a resumption of a growth trend in retail kilowatt hour sales, it appears that the over 60% reduction in PJM sales is continuing and thus the two factors tend to offset each other to some degree. Thus, while 1974 was indeed an unusual year for PEPCO when compared to the 1970-1973 period, the record indicates that 1974 level conditions, rather than those prevailing in 1973, are more representative of conditions reasonably expected to exist in the future.

A look at the future, therefore, indicates a new and different "normalcy" on which our predictions of things to come may properly be based. With that base, we believe that adherence to traditional regulatory concepts will give reasonable assurance of achieving the desired end result. We shall therefore follow that course here, and will now proceed to consider and determine the major issues of rate of return, rate base, expenses and rate structure.

Rate Of Return

Our analysis of the rate of return issue in this proceeding will begin at the beginning, *i.e.*, with a summary of the testimony of record on this subject.

Not unexpectedly, there is little variation in the evidence of record in respect of return requirements on (or capital cost of) debt and preferred stock. The relatively minor differences in expert opinion presented to us result not from differences in the precise mathematical calculations of the embedded costs of these senior securities, but rather from the inclusion or exclusion of short term debt and the use of different points in time to make the calculations, *i.e.*, embedded costs as of the time the testimony was prepared (early or mid-1975), or on pro forma costs anticipated to exist at year-end 1975. As indicated, the differences are minor, with calculated embedded costs ranging from 6.93% to 7.15%, and embedded costs of preferred within a range of 7.83% to 7.88%.

Similarly, equally minor differences arise in the expert witnesses views on PEPCO's capital structure. It appears from the record that the experts are in general agreement that PEPCO's capital structure consists of approximately 56% debt, 12% preferred stock, and 32% equity.

Expectedly, there are wider differences of opinion among the experts on the cost of (or return requirement on) PEPCO's common stock. It is to that issue that we must devote primary attention.

PEPCO's principle rate of return witness was L. Sanford Reis, who recommended a rate of return for PEPCO of 9.75% to 10.0%. Mr. Reis, whose qualifications as an expert witness on the subject of rate of return are beyond question, has testified frequently before this Commission. In his prior appearances, Mr. Reis' basic approach to the determination of return on equity has been of "comparable earnings." As we understand his testimony in this case, he continues to rely primarily on that approach, although he has also offered for consideration other methods which he used essentially as checks on or verification of the comparable earnings method. In arriving at his conclusion, Mr. Reis studied the realized return on common equity of 13

"comparison" companies and of PEPCO. His analysis showed that realized returns on average common stock equity have declined substantially since 1969, and that PEPCO's performance during that period has been well below the "comparison" companies.

It was Mr. Reis' view that the return required to attract equity necessarily increases by at least as much as the increase in debt costs, and because of the greater risk inherent in equity, probably more. Mr. Reis also noted the undisputed fact of institutional investor disenchantment with utility securities in general, the impact of attrition on equity earnings, and the need to attract outside capital to finance even PEPCO's drastically curtailed construction program. Consideration of all these factors, according to Mr. Reis, leads to the conclusion that PEPCO should be afforded an opportunity to earn between 15.5% and 16.0% on its common stock capital. Given today's economic conditions and trends, it was Mr. Reis' view that a "stated" return on equity in that range should permit PEPCO to actually realize an equity return of approximately 14.0% to 14.5%.

People's Counsel offered rate of return testimony through witness Edgar Bernstein, a former member of this Commission, now a consulting economist, who has presented testimony in a substantial number of utility rate cases before Federal and State Commissions. As with Mr. Reis, Mr. Bernstein's qualifications as an expert witness in the rate of return field are unchallenged. Mr. Bernstein, as did Mr. Reis, also selected a group of companies which he considered to be comparable to PEPCO. Unlike Mr. Reis, however, Mr. Bernstein used his comparable companies (and FPC electrics) to develop earning price ratios. To the arithmetically calculated earnings price ratios, Mr. Bernstein added an adjustment for the cost of flotation and pressure of 10%, and a second upward adjustment for future earnings growth and to accommodate market price at a reasonable margin above book value. On the basis of

his analysis, Mr. Bernstein concluded that a reasonable return on PEPCO's equity would be 11.5% to 12.5%. Adding the cost of senior securities, Mr. Bernstein concluded that a fair rate of return to PEPCO would be 8.70%, applied to an average net investment rate base for 1974, excluding construction work in progress (CWIP). Should the Commission include construction work in progress in the rate base and use an end of period rate base for purposes of determining revenue requirements, Mr. Bernstein's recommended rate of return is no higher than 8.5%. In his view, adoption of that regulatory approach would significantly reduce investor's risk.

People's Counsel witness Peter Karpoff, while not offering a full rate of return study, did submit a recommendation that the rate of return found reasonable by the Commission be applied to a capital structure consisting of embedded amounts of outstanding debt and preferred stock and the aggregate market value of outstanding common stock or its book value, whichever is higher.

The General Services Administration (GSA) on behalf of the Federal government as a customer, offered a rate of of return evidence through its witness Jerome Nicholas. Mr. Nicholas has testified for GSA in the last two PEPCO rate cases, and his approach to a rate of return in this case is essentially similar to his prior testimony. Mr. Nicholas uses essentially a comparable earnings approach, in which he reviewed and analyzed published financial data on bond yields, bond yield averages, prime interest rates, returns on equity; and compared financial data of 21 operating electric companies, including PEPCO, in terms of before and after tax interest coverages, experienced returns on common equity, growth in net income available for common equity, and debt ratios. On the basis of his analysis, Mr. Nicholas concluded that a fair and reasonable rate of return for PEPCO would be 8.75 percent, a figure which includes a return on equity of 12.18%.

The rate of return witness for the Commission staff in this case was David A. Kosh. Mr. Kosh's long and distinguished career as a rate of return witness includes innumerable appearances before this Commission and other State and Federal regulatory bodies, and although the discounted cash flow (DCF) methodology employed by Mr. Kosh has been the subject of differences of opinion, we are aware of no instance in which Mr. Kosh's qualifications as an expert witness have been questioned.

Simply stated, the DCF approach to a determination of the cost of equity is expressed in terms of a formula: the cost of equity is equal to dividend yield plus its anticipated growth. In applying the DCF formula in this case Mr. Kosh made several different analyses of the experienced growth of PEPCO and a group of eight companies which he considered similar to PEPCO, and on the basis of his analysis of annual rates of growth in dividends and book value per share concluded that a 3.0% annual growth rate for PEPCO and a 3.47% average annual growth rate for the eight similar electric operating companies could reasonably be expected by investors.

Similar analyses were made by Mr. Kosh in order to develop the dividend yield figure. Using the figures thus developed in the DCF formula, Mr. Kosh concluded that what he termed the "equity capitalization rate" for PEPCO was 11.75%. According to Mr. Kosh, however, the equity capitalization rate is a "bare bones" cost of equity, a rate insufficient to allow the sale of common stock at a price above book value, a fact which in the long run would result in dilution. It was Mr. Kosh's view that earnings on equity should be at a level which would tend, for the near term future at least, to keep market price about 20% above book value.

To achieve this result, Mr. Kosh made detailed studies of a group of 45 electric utilities in which he analyzed the

relationship between the rate earned on book and the market/book ratio. These studies lead Mr. Kosh to the conclusion that if PEPCO in fact earned, and if investors were persuaded that PEPCO were to continue to earn, at a rate of 13% on equity its market price would tend to be approximately 20% above book value. In Mr. Kosh's view, the 1.25% increase in the bare bones cost of equity figure would be sufficient to cover the cost of financing and pressure and to accommodate an anticipated further decline in market price in the near term future. Mr. Kosh's ultimate conclusion was that a fair rate of return would be 9.1%, a return which he found would provide an after tax coverage of interest of 2.3 times and a fixed charge coverage of 1.8 times, coverages which he concluded were both safe and an indication that 9.1% is indeed a fair rate of return.

Discussion And Conclusion

The ease of summarization of testimony on the rate of return issue is matched by the ease with which equitable legal principles may be stated. The classic tests of *Bluefield* and *Hope** remain valid. To be fair and reasonable, a rate of return must be sufficient to protect the financial integrity of the company, to maintain its credit and attract its capital, and to provide investors a return in line with that available from investments having comparable risks. While these principles may appear to be investor oriented, equally well settled is the principle that in reaching a conclusion on rate of return we have an obligation to protect the customer interest in rates that while sufficient to assure investor confidence are not excessive. It is, in short, this delicate balancing of investor and customer interest

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* *Bluefield Water Works & Improv. Co.* v. *West Virginia Public Service Commission*, 262 US 679, PUR1923D 11, 67 L Ed. 1176, 43 S Ct. 675; *Federal Power Commission* v. *Hope Nat. Gas Co.* (1944) 320 US 591, 51 PUR NS 193, 88 L Ed. 333, 64 S Ct. 281.

which we must strive to achieve, a balance which is often stated cannot be achieved by use of simple mathematics or mathematical formula. We are bound, or course by the evidence of record in this case, and it is on that evidence that we must make our judgment as to a fair rate of return for PEPCO. We are not bound, however, by the recommendation or methodology of any particular expert witness, and we must acknowledge here, as this Commission has in prior cases, our unwillingness or perhaps our inability to accept in total the methodology of any one witness. We recognize and we emphasize the essentially judgmental approach of each of the rate of return witnesses who testified in this case. The selection of comparable companies, for example, a process utilized by each of the four principal rate of return witnesses here, is almost entirely a matter of judgment. The appearance of objectivity introduced by the use of criteria for determining comparability is indeed an appearance, for the selection of criteria themselves involves basically an exercise in judgment. Needless to say the selection of criteria and the selection of comparable companies can produce widely varied end results.

These comments, directed particularly to the use of the comparable earnings approach, are equally applicable to the DCF formula or the use of earnings/price ratios. These two approaches to determing rate of return on equity suggest mathematical precision. However, each involves an exercise in judgment in the selection of companies and the selection of time periods to be analyzed in order to provide the mathematical data which is then substituted for the terms of DCF formula, or which appear in earnings/price ratio calculations.

Our emphasis on the judgmental aspect of these matters should not be construed as a rejection of that factor. Indeed, it is that factor and that factor alone which we must utilize in reaching our own conclusion as to a fair rate of return for PEPCO. It is in short our judgment that must

be translated into a mathematical figure; and on this record, it is our judgment that a fair rate of return for PEPCO is 9.1%.

We reach this conclusion for the following reasons. At the outset, determination of the cost of debt and the cost of preferred stock present no real problem. These are embedded costs and can be determined with mathematical precision. There are, it is true, differences in the experts' conclusions in this case.

With regard to embedded costs of debt capital, the mathematical result of an analysis of PEPCO's debt outstanding as of December 31, 1974, is 6.89%. The experts are agreed, however, that this figure must be adjusted to reflect the retirement in August, 1975, of some $10 million in debt securities carrying a 2.87% rate of interest. Mr. Reis and Mr. Kosh would further adjust debt cost in anticipation of a planned new 1975 issue by PEPCO of some $50 million in debt securities, with each witness arriving at a year-end 1975 cost of debt of 7.11%. To that cost, Mr. Kosh would add .4% to recognize as a cost of capital the compensating bank balances maintained by PEPCO to insure lines of bank credit.

In determining the cost of debt that we have used in reaching our rate of return conclusion, we have recognized and accepted known changes from the December 31, 1974, figure. In this regard, we are aware, both from our own records and from reports submitted to us by PEPCO, of which we may take official notice, that the $50 million debt issue anticipated by Messrs. Reis and Kosh was not made. Rather, it appears that PEPCO chose to meet its projected 1975 capital needs through short term borrowings, largely in the commercial paper market. Given these facts, it would be inappropriate to use the pro forma December 31, 1975 debt costs as precisely estimated by Messrs. Reis and Kosh. Rather, we have adjusted the calculated 1974 embedded debt cost to reflect only the August, 1975, debt

retirement and our conclusion that compensating balances are properly considered in cost of capital computations. The arithmetic of these adjustments produces a figure of 6.97%, a figure which we will round to 7% in recognition of the fact that at current costs of debt capital, any new debt issue by PEPCO will necessarily increase its embedded figure.

We come next to the cost of preferred stock. After the April, 1975, sale of preferred stock, the cost of that portion of PEPCO's capital structure is calculated at 7.83% (Bernstein), 7.84% (Reis) or 7.88% (Kosh). It appears that the difference between the 7.83% and 7.84% calculations of Mr. Bernstein and Mr. Reis, respectively, and Mr. Kosh's 7.88% is accounted for by Mr. Kosh's inclusion and repricing of convertible preferred. Mr. Kosh's rationale for this treatment begins with the observation that convertible preferred carries the characteristics of both fixed cost and equity capital, giving the owner a valuable option. Exercise of this option, according to Mr. Kosh, would act to dilute the earnings of existing shareholders; and repricing the convertible issue at straight preferred stock cost at the time of issue reflects true economic costs.

We find Mr. Kosh's reasoning persuasive, and we have therefore used 7.88% as the cost of PEPCO's preferred stock.

With regard to capital structure, our calculations indicate a current capital structure of approximately 55.4% debt and 12.3% preferred. Thus for purposes of determining rate of return for PEPCO our calculations reflect 55.4% debt at a cost of 7.0%, and 12.3% preferred stock at a cost of 7.88%.

We turn then to the more difficult task of determining the cost of common equity. As we have noted above, while it is possible to mathematically calculate the actually realized earnings on equity, there is no mathematical formula by which we could reach the magic number that will make

PEPCO common stock sufficiently attractive to investors to assure its purchase in the money markets.

Our review of the expert opinion testimony offered us begins with the recognition that it is not our function to determine the market price of PEPCO stock or to guarantee to investors a fair return on their stock. Rather, our role is to set retail rates reasonably designed to produce revenue which, if produced, would afford the Company an opportunity to achieve a reasonable return.

Viewing our function in this light, we must reject Mr. Bernstein's assertion that the cost of equity capital in this year 1975 is in a range below the 12.5% found reasonable by this Commission for PEPCO in 1973. We note in this connection that PEPCO's current cost of debt is approximately 10% and that PEPCO's preferred stock offering in April of 1975 was sold at a cost of 11.25%. We note also that in 1973 PEPCO sold common stock at approximately $15.00 per share, in 1974 at approximately $11.12, and 1975 at approximately $10.63 per share. The increased cost of senior securities and the decline in the amount investors are willing to pay for common stock of PEPCO are persuasive to us that investors today are demanding a higher return on equity investments than they were two years ago.

We are also unpersuaded that we should fix rates to be paid by District of Columbia customers of PEPCO on the basis of the "stated" return on equity proposed by Mr. Reis. In addition to what seems to us a patent unfairness to the District of Columbia ratepayers, we are troubled by two other points in Mr. Reis' testimony. First we believe that there are enough intangibles and uncertainties involved in the determination of the cost of equity without adding, as Mr. Reis did, an additional judgmental allowance of 1.5% to accommodate anticipated inflation or to reflect PEPCO's past inability to earn its authorized rate of return. Our second difficulty with Mr. Reis' testimony

is, not unexpectedly, in the area of his selection of "comparable" companies. We note, for example, substantial variations in achieved earnings among the companies selected, with the highest rate being earned in each year being at least 47% above the lowest. The use of an average necessarily obscures the variation, but is not persuasive that the average is comparable to PEPCO. We also note that of the 13 companies Mr. Reis selected only 4 that were regulated on the same basis as PEPCO, *i.e.*, original cost, a fact that further weakens the assertion of comparability.

Having rejected the two extremes, we turn now to the testimony offered by Mr. Kosh. We are aware, of course, that the DCF method used by Mr. Kosh has been both praised and criticized by the regulatory bodies over the years. We recognize, as we have indicated, that the DCF appearance of mathematical certainty is illusory, since the end result produced by the DCF formula is entirely dependent upon the judgment used in selecting the growth and dividend factors. It is in the area of judgment, rather than the use of the DCF formula, that we are impressed with Mr. Kosh's testimony. We find persuasive, for example, Mr. Kosh's point that the cost of equity is determined in the market rather than a comparison of earnings on book equity. We are also persuaded that the criteria used by Mr. Kosh in selecting comparison companies tend to eliminate to a substantial degree subjectivity and possibly bias in selections. We also agree that use of a recent period (also favored by Mr. Reis) provides a sounder indication of investors' expectations of earnings and dividends (and growth in each) than does, for example, the 1967-1974 period used by Mr. Bernstein. While today's investors may indeed research the history of a company, perhaps even from its beginning, it is our view that investors are more strongly influenced by the company's performance in recent years. Moreover, although predictions of the future in these troubled economic times is most difficult, we are convinced that experience during these times is a better

indicator of the future than a company's performance in the calmer times of the late 1960's.

We conclude, therefore that in order to attract equity capital, a return on equity of 13% is required by PEPCO; and we find an equity return at that level to be fair and reasonable.

That our judgment on the evidence of record arrives at the same result as that reached by Mr. Kosh should not be construed as a suggestion that Messrs. Reis, Bernstein and Nicholas have been of no help to the Commission. On the contrary, we have found the testimony of those witnesses invaluable in the formation of our own judgment in this case, and without their testimony we would have faced a difficult, if not impossible task in our effort to achieve that balance between customer and investor interest which is in the final analysis our function in making a rate of return determination.

To sum up this point, it is our conclusion that PEPCO's embedded cost of debt is 7%, its embedded cost of preferred stock is 7.88%, and its required return on equity is 13%. Application of these percentages to PEPCO's existing capital structure of 55.4% debt, 12.3% preferred, and 32.3% equity produces a calculated overall rate of return requirement of 9.05%. The precision of these calculations however, is both comforting and disturbing. In today's money markets, for example, there is no reason to believe that PEPCO could issue new debt or new preferred at the calculated embedded costs of those securities, and no doubt that any new issue of senior securities will increase those embedded costs. While we are reluctant to attempt to predict the future costs of debt and preferred stock, we cannot ignore current costs. We will therefore adjust the mathematically arrived at 9.05% rate of return to 9.1%, a future which in our judgment is just and reasonable under today's economic condition.

Rate Base

Having disposed of the difficult rate of return issue we now turn our attention to the question of what is the proper rate base to be used in determining PEPCO's revenue requirements for retail service in the District of Columbia. Here we begin with the proposition that PEPCO's system, which, serves customers in Virginia and Maryland as well as in the District of Columbia, is a unified, integrated electrical system. Generating plants and transmission lines, wherever physically located, are used to serve all PEPCO customers regardless of their geographical location.

Prior to 1970, PEPCO's operations in all three jurisdictions were regulated on a unified basis, with no effort being made to allocate costs or expenses among the jurisdictions. In 1970 however, this Commission, concerned that the more rapid suburban Maryland growth might have created a jurisdictional imbalance to the prejudice of customers within the District of Columbia, required PEPCO to make a jurisdictional allocation study. In the 1972 and 1973 cases similar studies were made by PEPCO, with all being found acceptable by this Commission.

We had in this case a jurisdictional allocation study, again prepared by PEPCO, and again utilizing essentially the same technique used in prior cases. This technique, known as the average and excess demand method, is one of three methods found generally acceptable by regulatory bodies. As explained by PEPCO witness, Frank Walters, the average and excess demand method involves essentially an allocation among jurisdictions of generation and transmission plant on the basis of average jurisdictional demands, a second allocation on the basis of peak demands, and a combining of the factors developed by these two calculations to produce the final percentage factor, which is then applied to the plant to be allocated.

Mr. Walters also presented for the record the results of an allocation on the basis of coincident and non-coincident peak demand, results which vary only a miniscule amount from the result reached by the average and excess demand method.

Other than the PEPCO study, which was reviewed and accepted by the Commission Staff, no other jurisdictional allocation studies were presented for the record in this case. There are suggestions in the record, however, suggestions which are more strenously argued on brief (particularly by the D. C. Department of Highways and Traffic) that because of the undisputed higher growth in demand in the suburban areas, all production plant installed by PEPCO since 1970 should be assigned to those areas.

We have several problems with this suggestion. First, as a purely factual matter the suggestion as stated ignores the fact of actual use of this more recently installed plant in serving customers in the District of Columbia. Secondly, the suggestion appears to ignore the fact that the average and excess demand method of allocation does reflect the more rapid suburban growth, as demonstrated by the declining share assigned to the District of Columbia in each of the years in which studies utilizing this method have been submitted to us. Third, while we are urged to make a "pragmatic" adjustment in recognition of the fact of steadily increasing unit cost of production plant, even pragmatic adjustments must be based on some supporting rationale. We are offered none on this record. Rather than arbitrarily adjust the jurisdictional allocation study, we believe it more appropriate to recognize the increasing unit cost of plant, a major contributing factor to the phenomenon called "attrition", in dealing with the rate structure issues that have been presented in this case. In our view, demand and cost causation are not peculiar to suburban customers, and those customers in the District of Columbia who contribute substantially to PEPCO peak demand

and who use the more recently constructed production plant should in all fairness shoulder their share, but no more than their share, of the burden of increased cost. We will therefore again accept the average and excess demand method of jurisdictional allocation, and deal with the problem of demand causation and peak load responsibility in our determination of appropriate rate schedules.

The next issue we must address under the heading of rate base is the perennial question of whether to use average or end of period figures. There is not, and indeed there cannot be, any question on this record that PEPCO has experienced a decline in earnings in the latter half of 1974 and that this declining trend shows no signs of a reversal. This fact, of course, does not in and of itself demonstrate the presence of "attrition." As the Commission said in the last PEPCO rate case "while a decline in rate of return may be the result of attrition, it may with equal validity be said to result from other factors, *e.g.*, imprudent investment or excessive expenses."

As we have indicated in our preliminary views, it appears to us that the major factors contributing to PEPCO's decline in earnings were the reduction in kilowatt sales to retail customers and the significant drop in sales to PJM. Putting these two factors aside, however, the record is clear that the increase in investment costs per unit of output noted in our last decision has continued; and in this case not only is this fact demonstrated by the actual dollar investment figures in the record but it is confirmed, we believe, by the vigorous advocacy on the part of consumer intervenors of the use of marginal or long run incremental cost figures for rate making purposes. The underlying theory of this advocacy is that the cost of new production plant is higher than the average embedded cost of that plant. Thus, while we are urged by some parties to match revenue, expense and rate base by using average rate base figures, we find little support in the record for

those recommendations. In short, we are persuaded that attrition is a phenomenon that is still with us, and we will therefore now, as we have in the past, use an end of period rate base, with appropriate adjustments, in order to compensate for the presence of attrition.

The point is made by PEPCO that use of an end of period rate base will only partially reflect the "attrition" in earnings that has taken place since our 1973 PEPCO decision. We are not persuaded, however, that the decline in earnings has been due solely to attrition, but has in large part been due to the drop in sales noted previously. Since sales to retail customers appear to have resumed a somewhat normal growth pattern, and since sales to PJM appear to have leveled off to a large degree, and since PEPCO has substantially reduced its construction budget, it appears reasonable to conclude that attrition in the future may play a less significant role than it has in the past.

A number of adjustments to rate base have been presented for consideration by our Staff and by several of the intervening parties in this case. People's Counsel witness McCabe, for example, with the support of other consumer parties, has urged elimination of construction work in progress from the rate base and substitution of an allowance for funds used during construction (AFUDC). Our Chief Accountant, Mr. Manheimer, noting the unusually large amounts included in construction work in progress at year end, has recommended averaging construction work in progress over the test period. Intervenor All Souls Unitarian Church has urged that PEPCO's investment in the Douglas Point Nuclear station be eliminated from rate base. Mr. Manheimer also recommends that we average materials and supplies over the test period, and that we eliminate amounts reflecting preliminary surveys, land transactions undistributed, prepaid insurance, and compensating bank balances, in our calculation of rate base.

We have given most serious consideration to all of these recommendations. We are disposed to agree with our Staff and accept Mr. Manheimer's recommendation for the use of an average amount of construction work in progress and an average amount in the materials and supplies account in rate base as more representative of the flow of dollars in and out of the accounts. The record shows wide fluctuations in these accounts over time and a substantial increase in fuel inventories in 1974, resulting from stockpiling due to the unusual fuel market in that year. The amounts at the end of the period in both accounts appear to be abnormally high. In view of PEPCO's projected reduction in its construction program and the reduction in fuel inventory in 1975, we do not believe that the end period figures can be called representative of anticipated future conditions. The adjustment of materials and supplies is consistent with the Commission's treatment accorded to this item in Formal Case No. 610.

With regard to Mr. McCabe's recommendation that construction work in progress be excluded from rate base (a recommendation subsequently modified to permit 10% of plant in service to be included as a construction work in progress allowance) we are disturbed by two factors. First, the 10% allowance appears to us to be wholly arbitrary and without foundation. Second, we would note that including CWIP in rate base without AFUDC and capitalizing AFUDC but excluding CWIP from rate base produce about the same ultimate result. Essentially, only the timing is different; but in the long run, use of AFUDC may result in a greater overall cost to the customer than inclusion in the rate base of construction work in progress. Projects begun in the period between rate cases, for example, earn no return under the CWIP approach, and if placed in service prior to the next rate case appear in rate base at the actual cost of the project. Were AFUDC used, the same project would appear in rate base at the cost of the project plus capitalized interest, and ratepayers would

be required to provide a return in that higher cost. In consideration of all factors, we believe that the interest of both customer and investor would be better served by continuing our long standing practice of allowing PEPCO to include construction work in progress in its rate base.

With regard to the Douglas Point nuclear project, there is no question but that substantial funds have been invested in that project, and that nuclear projects require an extraordinarily long lead time required to plan and complete. We understand and appreciate the views expressed by All Souls witness Father Millard in support of his recommendation that the $28.6 million already invested in Douglas Point now be excluded from rate base. In consideration of current fuel uncertainties and the 8 year or longer lead time, however, we are not convinced that we should at this time declare the nuclear project imprudent or unnecessary.

We are disposed to agree with our Chief Accountant that amounts reflecting preliminary surveys and undistributed land transactions should not be included in rate base. As Mr. Manheimer has pointed out, there is no certainty that any of these amounts will be transferred to plant in service and for that reason we believe their exclusion is appropriate. Similarly, we agree with Mr. Manheimer that prepaid insurance premiums and compensation bank balances should be excluded from rate base, since insurance premiums are expensed over time and compensating bank balances are in our view more properly a part of the cost of money and have been included in our calculations of fair rate of return.

For these reasons, then, and having considered all data and recommendations of record, we find the appropriate District of Columbia rate base to be $650,091,000, as shown on Attachment A, Page 1.

To achieve a 9.1% rate of return on a rate base of $650,091,000, PEPCO's operations must produce a return

of $59,158,000, as shown on Attachment A, Page 3. We turn now to consideration of observed expenses and operating results, from which we may determine the amount of revenues needed to produce this net return.

Expenses And Operating Results

On this record, few if any questions were raised about the income, expense, and operating results recorded on the PEPCO's books. A number of adjustments in those figures were proposed however, some by PEPCO, some by our Staff, and some by intervenor parties.

Among these adjustments, the one with the most substantial dollar impact was PEPCO's proposal for a new depreciation rate. PEPCO's current depreciation rate of 2.94% was approved in 1971 on the basis of a study required by and performed for the Commission. In this case, PEPCO presented a new depreciation study prepared by its witness Ritter, a well recognized expert on the subject of depreciation. Mr. Ritter also prepared the study for the Commission in 1971.

That portion of Mr. Ritter's study relating to traffic signal and street light plant was sharply criticized by the D.C. Department of Highways and Traffic. Portions of the study were also questioned by GSA, and Mr. Ritter's entire study was considered unacceptable by People's Counsel. The Commission's Chief Accountant, Mr. Manheimer, however, testified that he and his satff had reviewed Mr. Ritter's study and found it to have been done in a manner consistent with prior depreciation studies of PEPCO as approved by this Commission and in accordance with accepted practices and procedures. Mr. Manheimer also recommended acceptance of the study and its results by the Commission, for the reason that accuracy in depreciation rates and depreciation accounting are of great importance today in view of the substantial additions to plant made by PEPCO in recent years. As Mr. Manheimer pointed out, PEPCO's plant in service, now about $1.5 billion,

increased by about $600 million in the last years. Sound regulation requires, in our opinion, that depreciation rates and the resulting depreciation reserve be neither overstated nor understand, particularly when we are dealing with figures of this magnitude.

We are troubled somewhat by PEPCO's departure from past practice in instituting a depreciation study on its own initiative. Past practice has been for the Commission to order depreciation studies at times of the Commission's own choosing, and we remain convinced that sound and effective regulation requires control by the Commission over the amount, direction and timing of depreciation rate changes. We will accept the PEPCO depreciation study in this instance, but henceforth our past practice of ordering depreciation studies is to be followed.

The change in depreciation expense resulting from the change in depreciation rate necessitates a change in the depreciation reserve. PEPCO has proposed an appropriate adjustment to the depreciation reserve figure, and we will accept that adjustment.

A second rate making adjustment having significant dollar impact was PEPCO's proposal that it be permitted to "normalize" the four percent investment tax credit over the full anticipated use of the assets giving rise to the credit, *i.e,* some thirty-one years. In prior PEPCO cases, this Commission has recognized the fact that investment tax credits in any particular year may vary widely from credits from the year before or the year following. Our past practice has been to require an averaging of investment tax credits over first a four-year period, and in more recent decisions over a six-year period. PEPCO now contends that the six-year averaging convention would not adequately normalize fluctuations in the investment tax credit, and that therefore full asset life normalization is necessary. PEPCO's proposal is vigorously opposed by People's Counsel on two grounds: first, as unnecessary to even

out fluctuations; and second, as merely a device to enhance PEPCO's internal cash generation and its earnings quality by making ratepayers involuntary lenders to PEPCO.

We find no evidence in the record that persuades us that it is necessary to extend the six-year convention to thirty-one years for the purpose of smoothing out variations in year to year investment tax credit. We are therefore disposed to agree in part with the position taken by People's Counsel on this point and will use the six-year convention as approved by the Commission in the prior PEPCO decision (Formal Case No. 596); and although we recognize PEPCO's desire to improve its earnings through any and all avenues of relief that might be available to it, we will undertake to fulfill our responsibility to PEPCO through more direct means, rather than requiring the ratepayer to advance substantial sums of money to PEPCO over the next thirty years.

People's Counsel has proposed two other adjustments to test year operating results which we find less persuasive. The first of these, which would recognize the uncontroverted fact that PEPCO's sales to retail customers were significantly lower in 1974 than 1973, suggests an increase of approximately $6 million in operating income to reflect this sales decline. We have two problems with this proposal: first, we find no evidence in this record on which to base a conclusion that operating results in 1975 will achieve 1973 levels of retail kilowatt hour sales, much less reflect a growth in sales over 1973 at the growth rate existing in the 1970-1973 period; second, even if there were such evidence, the amount to be added to operating income in the test year is, on this record, speculative at best.

It is possible, of course, to mathematically calculate a revenue figure if we were to assume a specific number for revenue per kilowatt hour of sales. The problem here is that we do not know and cannot determine when, to which customers, and at what rates these hypothetical additional

kilowatt hours would have been sold. Additionally, as PEPCO points out, revenues cannot be adjusted without calculating the expenses that would have been incurred in producing those additional revenues. To the revenue uncertainties we have noted must be added the further uncertainties of fuel and other expenses, perhaps offset in part by additional sales to PJM. These expense hypotheticals would convert such a mathematical exercise to pure speculation. We decline to indulge in that speculation.

People's Counsel also proposes an adjustment to operating results to give effect to weather normalization. While we have no conceptual difficulty with the concept of weather normalization, and recognize it as an adjustment quite commonly made in the gas utility field, we are not persuaded that such adjustment is appropriate, in any case, for an electric utility. It is not appropriate in this case. The record here suggests, in fact, the impossibility of defining "normal" weather conditions for a utility such as PEPCO, since a review of the 20-30 year weather averages shows a deviation in yearly experience of greater than 6 percent in each year but three and in excess of 10 percent in fourteen of the 22 years examined, with an average deviation of 16 percent.

Another adjustment, proposed both by People's Counsel and our Chief Accountant, would annualize test year interest expense to reflect changes in expense brought about by changes in the Company's debt securities, thereby reducing income taxes. We believe this adjustment, recognizing as it does a known change, is appropriate. It will be made. In addition, we will accept the Staff adjustment which places commitment fees "below the line."

PEPCO has proposed two additional adjustments: first, that its wage and salary expense figure be increased to reflect a new union contract, and to acknowledge increases normally given management employees during the year; second, that its tax expense be increased to reflect an

anticipated change in the District of Columbia gross receipts tax rate.

We are persuaded that the wage and salary increase for unionized employees is a proper factor for adjustment in this proceeding. With respect to union wage increases, it is a fact of labor management contract life that PEPCO is obligated, in an amount certain, to increase wages of its craft employees. With regard to management salary increases, we do not agree that the adjustment requested by PEPCO should be made. We are persuaded that the uncertainties as to amount, timing, and fact of these projected increases are such that the proposed adjustment cannot be made.

With regard to the proposed adjustment for a gross receipts tax increase, we may take official notice of the fact that the District of Columbia gross receipts tax rate has now been changed from 5% to 6%. Since the tax rate change is now both known and effective, we will make the appropriate adjustment.

Additionally, although not requested by PEPCO, we must take official notice of the fact that the District of Columbia corporate franchise tax rate has now been increased to 9%, and we are constrained to also adjust our tax computations to reflect that change.

PEPCO has also requested that it be authorized to pass on to District of Columbia customers, as an operating expense, that portion of payments made to the State of Maryland's environmental trust fund properly allocable to the consumption of electricity in the District of Columbia. While we are troubled by the proposition that District of Columbia customers should provide funds to the State of Maryland, we are persuaded that, as revised, the Maryland Environmental Trust Fund is not a tax by Maryland on District of Columbia residents but rather is an appropriate and necessary PEPCO operating expense. Since the basis

for payment is power and energy generated in Maryland, a substantial portion of which is used in the District of Columbia, we believe that the portion of this operating expense represented by energy consumed within the District of Columbia, we believe that the portion of this operating expense represented by energy consumed within the District should be properly be borne by District of Columbia ratepayers. We are not persuaded however, that D.C. residents should be required to pay the 1.5% collection fee provided by the Maryland statute, and we shall therefore disallow that amount. We intend to keep this entire matter under review, and our action here is without prejudice to our right to reach a different conclusion should changes in circumstances occur which, in our judgment, would warrant a different judgment.

At this point, then, having concluded that a 9.1% rate of return on a District of Columbia rate base of $650,091,000 requires a return of $59,158,000, and that PEPCO operating results, as adjusted in accordance with our conclusions, indicate a realization under currently effective rates of some $12,302,000 less than required, we turn now to the question of rate schedules and rate levels which will afford PEPCO an opportunity to achieve that level of earnings. Giving effect to taxes, this additional net income equates to some $27.7 million in additional revenues.

Rate Level And Rate Structure

Of all the issues in this proceeding, the issue of rate structure drew the most attention.

PEPCO's proposed rate structure follows, in large part, the trend toward rate simplification and rate flattening that has prevailed over the past several years. Offered for our consideration were also a variety of proposals from customer intervenor parties, most of which have as a central theme the proposition that rates should be set on the

basis of long run incremental costs. Specific criticism of PEPCO's proposed rate structure was offered, insofar as their particular interests were involved, by the Apartment and Office Building Association, the General Services Administration, the D.C. Department of Highways and Traffic, and the AC/DC Committee, which spoke for the all electric residential customers in the District of Columbia.

Turning first to the proposition that long run incremental cost should be the basis for retail rates we must acknowledge the confusion on this record arising from the apparent use of the terms "marginal" and "long run incremental" as interchangeable. As we understand it, marginal costs and long run incremental costs are not synonomous, yet these concepts appear to be so used by some intervenor witnesses. Given our understanding of these concepts, *i.e.*, that marginal costs include essentially only the out of pocket costs of supplying an additional unit of output, whereas long run incremental cost includes the additional cost of capital investment required for the additional unit, we find the recommendations and arguments of People's Counsel and residential intervenor groups persuasive on this point. To the degree that increased demand requires the installation of additional production capacity, at higher than existing embedded unit costs, it appears that long run incremental costs should be considered in establishing rate schedules.

Implicit to us in the theory of long run incremental cost pricing are the concepts of peak load and time of day pricing, both of which also appeal to us in the light of the current costs of producing and delivering electric energy in the District of Columbia. The theory that those who cause the costs should bear them seems to us to be not only good economics and sound regulatory practice, but is fair and equitable as a matter of common sense. We recognize, of course, that long run incremental costs may be difficult to determine with great precision, but by the same

token we do not believe that rate making is an exact science or that rates must or may be set to recover precise costs in each instance. There are, as the record in this case clearly shows, other factors which must enter into the development of just and reasonable rates.

All parties to this proceeding appear to recognize the presence of three components of cost in producing and distributing electric energy: (1) customer cost, which includes meter reading, billing and connection costs, costs which are incurred whether the customer uses any or no energy; (2) demand cost, which includes generation, transmission and distribution capacity cost which may vary with kilowatt demand but generally reflects the total cost of capacity committed by the utility to provide service to its customers whether used or not; (3) energy costs, which include essentially the operating and maintenance cost associated with supplying a given number of kilowatt hours and which vary directly with the amount of energy produced and consumed.

Each of these cost components has felt the effect of inflation, and were each to be priced today at its long run incremental cost, the impact on existing rate schedules would be staggering.

We find persuasive the theory that the demand component of electric rates should be set with reference to long run incremental costs. We are troubled, however, by variations shown by the record in the definition of long run incremental cost. We are further troubled by the apparent assumption that rates based on long run incremental cost should be applied to all units of consumption, which by definition reflect average costs generally different from and lower than the long run incremental cost.* In short,

* This was demonstrated by the excessive revenue produced under the LRIC rate proposals advanced by several intervenors.

the concept of long run incremental costs, as we understand it, is the cost of *additional* units of output. And if *additional*, it necessarily follows that there exists a base to which the addition can be made. Thus, while we are in agreement with the theory, its full implementation on this record at this time does not appear possible. We do not have an adequate showing of base costs, particularly by customer class nor do we have on this record a satisfactory definition or calculation of long run incremental costs.

Nevertheless, we do believe that the evidence of record is adequate to strongly support the studies currently underway by PEPCO and the further studies which we shall direct PEPCO to make. We also believe the record supports a beginning now, rather than at the conclusion of PEPCO's proposed studies, of a movement in the direction of long run incremental cost pricing.

In this context we believe that PEPCO's proposal to flatten the summer residential rate is a step in the right direction. We note and agree with the recommendation of People's Counsel witness KARPOFF that a single rate for all residential consumption be adopted higher in summer and lower in winter. Given the increased and increasing unit costs associated with the provision of electric service, we see no justification for continuation of volume discount rates. Moreover, energy conservation remains a national goal, and in our judgment flat rates will help achieve that goal. Additionally, with respect to the residential class of customers, we remain of the view expressed in our last PEPCO case that basic use of residential electric service in the District of Columbia has not caused and does not contribute to the need for new and increased plant investment by PEPCO. The average consumption of energy in the District of Columbia for residential customers is 450 KWH per month. For this reason, and in an effort to encourage energy conservation without penalizing essential use, we will require that no part of the base rate increase authorized shall be applied to monthly residential

consumption below 450 kilowatt hours. To the degree that this may require a shift in revenue requirements, we will direct that the amount involved be spread among all customer classes in proportion to the percentage increase for each class proposed by PEPCO.

For the same reasons, we also believe this flat rate principle should be applied to the commercial low voltage rate structure. PEPCO's proposed increase in the demand charge for large power users is also, in our judgment, a step in the right direction, since it tends to flatten the conbined demand and energy schedule. Again, in regard to large power customers, the record indicates the existence of graphic demand meters currently in service for most of these large customers, meters however, that for the most part measure kilowatts of demand rather than kilowatt hours. We believe that these large customers should be put on a peak load, time of day, rate schedule and we shall therefore direct PEPCO to proceed forthwith to obtain and install appropriate meters and associated equipment for these large customers, to complete that installation within a period of one year from the date of this order and to file sufficiently in advance of the expiration of the one year period a new tariff to reflect time of day, peak load pricing.

We are persuaded that the existing and proposed rate schedules are inappropriate in their application to all-electric residential customers in the District of Columbia and may also be inappropriate in their application to residential tenants living in apartment houses which receive electricity under the general services schedule. We are aware of the problem involved in apartment metering, where the apartment building may contain, in addition to residential units, commercial units. We do not believe, however, that the problem is insurmountable, and we shall therefore direct PEPCO to immediately conduct a study of the apartment segment of the general services class to determine

whether discrimination exists between residential apartment tenants (who are users but not customers) and customers under the residential schedule. The possibility of discrimination and adverse impact on low income residents was graphically portrayed in this case by the testimony of Lincoln-Westmoreland Housing witness Hindrichs, and PEPCO may wish to consider beginning its study with an analysis of that project.

The results of this study, which will be designed in consultation with an agent to be appointed by the Commission, shall be reported to the Commission within six months of the date of this order, and the Company shall simultaneously forward its proposals, if any, for establishment of a new or changed classification of residential users and a new tariff.

With regard to the all-electric customers we do not believe that further study is required. The evidence of record is sufficient, we believe, to permit the immediate preparation and filing of a new tariff schedule for this class which reflects the off-peak nature of the electric heating load, and relates the return earned from this customer class to the Company's return from all residential customers as a class. We shall direct PEPCO to do so promptly. In this connection the Company is urged to consider an optional time-of-day peak load pricing tariff for these customers. Additionally, we are persuaded that the all-electric concept, initially introduced as a promotional effort, no longer serves the public interest. The new schedule for the all-electric customer will be available only to those customers receiving that type of service on the effective date of the tariff, and shall specifically provide that no new customers will be added after that date.

The ultimate goal of this and all rate making proceedings is a tariff structure and rate design that will be equitable to all of PEPCO's customers, provide the overall revenue to be allowed and, to the extent practicable, attain

other broad objectives advocated here and elsewhere such as conservation of energy, optimum allocation of resources, independence from foreign energy suppliers, reduction in capacity needs, and relief to low and fixed income consumers. At this time, it is clear that many of the views expressed in this proceeding are without the benefit of adequate factual data on the manner in which various proposed rate reforms would be implemented, whether they would accomplish desired objectives, and their impact upon customers. Further study is required to evaluate the desirability and feasibility of attaining any or all such objectives through reforms in utility rates.

In addition to the particular study heretofore specified, we will by subsequent order direct PEPCO to undertake a study of the feasibility and efficiency of implementing various proposed rate making theories and rate forms on its system including average cost pricing, marginal cost pricing, long-run and short-run incremental cost pricing, peak load pricing, time-of-day pricing, flat rates, "lifeline" rates, inverted rates, service charge in rates, and such other rate forms as may warrant consideration.

There remains the issue of rates for street lighting and traffic signals in the District of Columbia. On this item, we have carefully reviewed the record and the numerous contentions advanced by the D. C. Department of Highways and Traffic. Among the Department's contentions are that PEPCO has "doubled counted" equipment and facilities allocated to street lighting service; has improperly applied the composite depreciation rate to those facilities; has failed to recognize the load characteristics and patterns of street lighting demand; has used an unjustified "burning hour" calculation for non-metered service; and has improperly allocated expenses on the basis of lumen output rather than actual operating and maintenance costs.

We have thoroughly reviewed the somewhat voluminous record on these points, but find little, if any, factual support for many of the Department's contentions.

Our review also indicates that most, if not all of the contentions urged on us in this proceeding are similar to if not identical with contentions raised by the Department in previous proceedings. We remain of the view that application of the composite depreciation rate is proper, that PEPCO's allocation of investment and expense to street lighting is appropriate, and that many of the Department's contentions, even if persuasive, would have no measurable effect on street lighting rate schedules.

Two points urged by the Department, however, are persuasive. Its witness, Basaran, points out, for example, an apparent discrimination in the treatment of the Department in terms of the "burning standard" for unmetered street lights. The Department is currently billed for energy used in these installations on the basis of 4200 burning hours per year. Other customers are billed on a lower "burning standard." The study on which this standard is based appears to have been conducted in Maryland some five to eight years ago. The age of the study and the criticism of its results convince us of its inapplicability to today's circumstances. We shall therefore direct PEPCO to undertake a new study of burning hours in the District of Columbia, and pending its completion to bill the Department for this category of service on the basis of a burning standard no higher than the 4033.8 hours it uses for Maryland street lighting.

We are also concerned with regard to the question of our authority to allow charges for energy for street lighting in excess of 2 cents per kilowatt hour. Our position on this matter has been clearly stated in the Commission's April 9, 1975 letter to the chairmen of the cognizant Congressional committees and the City Council, *i.e.*, "We believe it is the intent of the Congress that the Commission's

jurisdiction in this area be exclusive and plenary. . .". Our letter further stated our approval of the currently effective street lighting tariff rate of 2 cents per kilowatt hour plus the fuel adjustment surcharge, and pointed out the difficulties in properly distributing increased revenue requirements in the face of an appropriations limitation on one class of service.

We are informed that efforts to clarify this matter have been undertaken. Until the question is resolved, however, we believe that unilateral action on our part might be both presumptious and counter-productive. We shall therefore require continuation of the existing tariff for street lighting energy pending definitive Congressional action.

As a general observation, we believe that many of the Department-PEPCO difficulties are the resulting of misunderstanding and we believe that much can be accomplished by a continuation and intensification of discussions between PEPCO and the Department. We urge that this be done.

The final problem of significance in the rate structure area is the question of PEPCO's proposal for a new fuel adjustment charge. Under its proposal, PEPCO would remove from the base rates the entire cost of fuel and include that cost as a separate charge, offset in part by credits resulting from the sale of energy and capacity to the PJM system.

The short answer to PEPCO's proposal, in our judgment, is that it is wholly unfair to PEPCO's customers. As observed repeatedly on the record in this proceeding, the PEPCO proposal totally removes any incentive for reducing or minimizing fuel costs; and although we may maintain constant surveillance over PEPCO's operations in this area we are of the view that retention of the profit motive would perhaps be a more powerful incentive to reduce costs than our regulatory supervision. We will therefore disapprove the PEPCO proposal for a new fuel adjustment

clause, and direct PEPCO to continue in effect its present fuel adjustment clause, modified to include only increases in costs reflected in Account 151, which includes only the cost of fuel, transportation, and related items. The cost of such items as disposal of ash, fuel handling and fuel procurement will be reflected in base rates.

Miscellaneous

There remains one item which does not fit neatly into the categories of rate of return, rate base, expenses, operating results and rate structure. This item is the contention of the Washington Public Interest Organization (WPIO) that PEPCO's revenue requirments to reduced because of a realized gain from the sale and transfer of PEPCO property previously devoted to public service. We are aware of course, of the judicial opinion on which the WPIO contention is used.* We do not, however, view that decision as controlling in this case. Apart from the question of jurisdiction (our decisions are not subject to review by the United States Court of Appeals for the District of Columbia Circuit), we believe that the unique factual situation presented to the court in that case is not present here. The properties in question in this case, which PEPCO has placed "below the line" were not acquired at a price below book value, nor under any special circumstances such as existed at the time of enactment of the D. C. Transit franchise act. Nor has there been an accounting treatment which would lay a basis for ratepayers to claim an interest in these properties. Accordingly, we find the exception to established regulatory principles recognized in the *Democratic Central Committee's* case inapplicable.

Treatment in accordance with the Company's handling of this matter is in accordance with the F.P.C. Uniform System of Accounts which this Commission has adopted,

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* Democratic Central Committee v. *WMATC, 485 F.2d 786 (D. C. Cir. 1973).*

thereby establishing its policy on this issue An *ex post facto* change in this policy would be inappropriate.

Findings Of Fact And Conclusions

The Commission finds and concludes on the evidence of record the following:

1. That the use of an end-of-period rate base with adjustments to average construction work in progress and materials and supplies is appropriate.

2. That the year ended December 31, 1974 is an appropriate test period and that PEPCO's District of Columbia rate base as of December 31, 1974 is $650,091,000, as shown on Attachment A, Page 1.

3. That the test period operating results, as adjusted, show operating income for the period of $46,856,000, as shown on Attachment A, Page 2.

4. That a fair rate of return to PEPCO is 9.1 percent and that this figure, related to the rate base of $650,091,000 indicates a revenue deficiency of $12,302,000.

5. That in order to realize a 9.1 percent rate of return on its test year rate base, the Company must increase its District of Columbia operating revenues by $27,657,000 after allowing for taxes as shown on Attachment A, Page 3.

6. We find, pursuant to Rule 17.1, that the increase is cost justified and does not reflect future inflationary expectations; it is the minimum required to assure continued, adequate and safe service and to provide for necessary expansion to meet future requirements; it is intended to achieve the minimum rate of return necessary to attract capital at reasonable costs and yet not impair the credit rating of PEPCO; and it takes into account expected and obtainable productivity gains.

We conclude, therefore, that PEPCO should prepare and submit for our approval rate schedules consistent with this opinion which are reasonable and appropriate in this decision.

THEREFORE IT IS ORDERED:

Section 1. That PEPCO should be authorized to file and put into effect rate schedules calculated to produce approximately $12,302,000 additional net income;

Section 2. That to produce this amount of additional net income, PEPCO rate schedules should be designed to produce some $27.7 million additional gross revenue;

Section 3. That PEPCO should be authorized, and it is hereby authorized, to prepare and file, subject to our approval, rate schedules which comply with our findings and directions and which are calculated to produce $27.7 million additional revenue; provided however that:

(a) Said rate schedules shall not provide for any increase over current rates for the first 450 kilowatt hours of electricity sold to customers under the residential rate schedule, and

(b) A separate schedule of rates shall be submitted which shall be applicable solely for existing all-electric residential customers.

Section 4. That, by not later than one year from the date of this Order PEPCO shall have installed meters at the facilities of its large power customers which are designed to operate pursuant to a peak load, time of day rate schedule.

Section 5. That, in addition to the rates otherwise to be filed pursuant to Section 3 above, PEPCO shall

also file with the Commission a new tariff schedule applicable to those customers specified in Section 4 above which shall be based upon time of day, peak load pricing principles. Said tariff schedule shall be filed at a date sufficiently in advance of the one-year deadline set in Section 4 above so as to give the Commission reasonable opportunity to review and act upon said tariff schedule by the one-year deadline.

Section 6. That PEPCO shall undertake a study of the apartment house segment of the general service customer class in order to determine whether an unreasonable discrimination exists between apartment house residents (receiving service pursuant to the general services rate schedule) and customers receiving service under the residential schedule. PEPCO shall submit said study to the Commission by not later than six months from the date of this Order.

A True Copy By the Commission:

/s/ Ruth Hankins-Nesbitt
Chairperson

Chief Clerk

Majority Opinion By:

Ruth Hankins-Nesbitt, Chairperson
H. Mason Neely, Vice Chairman
Dissent Opinion By:

William R. Stratton, Commissioner

ATTACHMENT A

POTOMAC ELECTRIC POWER COMPANY
FORMAL CASE NO. 630
DISTRICT OF COLUMBIA
RATE BASE FOR THE YEAR ENDED DECEMBER 31, 1974

Electric plant in service	$655,274,000
Experimental electric plant	2,915,000
Electric plant held for future use	2,355,000
Electric plant acquisition adjustments	142,000
Construction work in progress	104,356,000[1]
Materials and supplies	28,448,000[1]
Cash working capital	11,958,000
Accumulated provision for depreciation	(151,717,000)
Accumulated provision for amortization	(234,000)
Customer advances for construction	(6,000)
Accumulated deferred income taxes	(3,400,000)
Total Rate Base	$650,091,000

NOTE:

[1] average

POTOMAC ELECTRIC POWER COMPANY
FORMAL CASE NO. 630
DISTRICT OF COLUMBIA
OPERATING REVENUES, EXPENSES AND NET OPERATING INCOME
TEST YEAR ENDED DECEMBER 31, 1974

Operating revenues	190,054,000
Operating expenses:	
Operation and maintenance expenses	99,333,000
Depreciation expense	19,666,000
Amortization expense	78,000
Taxes—other	18,651,000
Federal income taxes	5,470,000
Total operating expenses	143,198,000
Net operating income	$46,856,000
Pro forma Rate of Return	7.21%

POTOMAC ELECTRIC POWER COMPANY
FORMAL CASE NO. 630
COMPUTATION OF ADDITIONAL REVENUE REQUIREMENT
APPLICABLE TO THE DISTRICT OF COLUMBIA

Net Rate Base	$650,091,000
Return at 9.1%	$59,158,000
Net Utility Operating Income	$46,856,000
Deficiency in return	$12,302,000
Complement of Composite Tax Rate	44.48%
Additional Revenue Requirement	$27,657,000

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA

1625 I Street, N. W., Washington, D. C. 20006

November 12, 1975

IN THE MATTER OF

Application of POTOMAC ELECTRIC POWER COMPANY for an Increase in its Retail Rates for the Sale of Electric Energy	Formal Case No. 630

Dissenting Opinion Of Commissioner Stratton

With today's decision the Commission takes a giant step—backwards. Backwards into the rate-making ethos of a departed era when the harsh realities of an uncertain energy environment, and rampant inflation were not with us. Today's decision denies the reality, abundantly demonstrated in the record, of remorseless price escalation in virtually every component of the cost of service, and by doing so insures the prompt relitigation of all the issues in this case.

The real issue in this case is whether this Commission can so demonstrate its understanding of this utility and the world in which it must exist as to issue a rate order under which the utility can operate for a reasonable period of time without returning to us in quest of higher rates. This we have failed to do. Our failure is rooted in our denial of known and inexorable upward pressures on operating and capital costs, with which revenues must keep pace if a utility is to fulfill its service obligation.

I

These considerations of inflation and uncertainty could best have been addressed in dealing with the so-called attrition effect, which requires separate consideration in traditional, test year rate-making as practiced by this Commission.

To understand the attrition effect one must recognize that the test year approach to rate-making is a forecasting methodology, as it must be, since rates are made for the future. The test year approach is implemented as follows: a recent 12-month period (calendar 1974 in this case) is selected as the test year; financial results of that year's operations are used as the base data in the analytical process; known changes are reflected as pro-forma adjustments to the test year operating results; rates are established at a level that, applied to test year usage, will produce sufficient revenue to cover test year expenses as adjusted and provide the funds necessary to produce a fair rate of return on the adjusted test year rate base.

The purpose of this exercise, and its theoretical justification it must be emphasized, is *not* that future rates are reasonable if in the test year they would have produced a fair return, or that the increase in revenues that would have produced a fair return in the test year is *ipso facto* the increase that will do so in the future. The test year approach assumes—and this is vital to an understanding of it—that the *relationship* among revenues, expenses and rate base that obtained in the test year will continue into the future. Only if this assumption is valid does it follow that rates which would have produced a fair rate of return in the test year will produce a fair rate of return in the future.

If this assumption as to continuance of relationships holds true, an increase in sales revenues will be accompanied by an equivalent increase in expenses and in rate

base; and the utility will earn at the authorized rate notwithstanding the differences in experienced future revenues, expenses and rate base from those of the test year.[1]

If test year relationships among revenues, expense and rate base do not continue into the future, then the rates ordered on the assumption the relationship will continue are ineffective to produce the results contemplated by the order.

If revenues rise faster than both expenses and rate base, excessive returns are produced; if revenues rise faster than expenses (and rate base does not rise enough to require application of the excess funds thus produced to meet the fair return requirement on rate base) excessive return is produced; or, if revenues rise faster than rate base (and expenses do not rise enough to absorb the excess funds thus generated) an excessive return results.

Conversely, if rate base and expenses both rise faster than revenues a return deficiency results. A return deficiency also results if the faster rate of increase is experienced only in rate base or only in expenses, unless the revenue shortfall resulting from the faster increase in one cost component is offset by slower than anticipated increases in the other. This erosion of return by cost component increases that outpace revenue increases is known as attrition.

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[1] To illustrate: if R=revenues, E=expenses and B=rate base, the rate of return is found by the formula [R-E]÷B. If revenue rises by 10% to 1.1R the test year approach assumes that expenses and rate base will maintain their relationship to revenues and also rise by 10%, *i.e.*, to 1.1E and 1.1B. In this situation earned rate of return will be found by the formula [1.1R-1.1E]÷1.1B. Dividing through by 1.1 the formula is again expressed [R-E]÷B producing the same rate of return as authorized on the basis of test year data.

The attrition effect has been felt in the electric utility industry for the past five years, as is illustrated by the results of a recent survey comparing authorized rates of return for the industry with actual earnings:

	1970	1971	1972	1973	1974
Equity Return Authorized	11.97%	12.09%	12.33%	12.2%	13.01%
Return Earned	11.76%	11.64%	11.74%	11.45%	10.96%

As these figures show, actual earned returns on equity have declined, even as state regulatory commissions have authorized ever higher rates of return based on a test year. Obviously the rate of growth in expenses and rate base has exceeded the rate of revenue growth, and the effect has been felt on earnings as demonstrated by inability of the industry to achieve earnings that approach levels found reasonable by regulators. PEPCO is no exception.

Obviously the revenue/expense/rate base relationship is dynamic. The relationship that existed in the test year is never exactly maintained in the future. To that extent the test year device is imperfect, but, like democracy, it is probably better than the alternatives. This imperfection is compensated for in some measure by adjusting test year data in order that it better mirror the future, typically by taking into account known changes that are not fully reflected in test year data, such as annualizing a wage increase that occurred part way through the test year, thereby recognizing a level of expense that will continue throughout an entire future year. Sometimes test year data are adjusted to take account of events occurring after the test year; a wage increase occurring during the pendency of a rate case might be an example. Some such adjustments have been made in this case.

However, the assumption that the revenue/expense/rate base relationship expressed by the adjusted test year data

upon which this order is based will continue for a reasonable period into the future is not valid. This order assumes lower expenses and rate base in relation to revenue than will occur. The record abundantly demonstrates, and the majority decision acknowledges, the increasing expense and the increasing rate base required to produce a unit of sales, and the 1975 data admitted into the record bear this out.

The Commission itself has acknowledged the present invalidity of the revenue/expense/rate base continuity assumption in its solemn finding that attrition does in fact exist for this company, no other finding being possible on the record in this case. Where I part company with the Commission is in its treatment of the attrition malady for which the remedy prescribed lies somewhere between a placebo and blood-letting.

II.

The Commission purports to countervail the rate base attrition effect[2] by granting an end-of-period rate base for plant in service.[3] Since the value of plant-in-service at the end of the test year was more than the average value of this component of rate base, this has the effect of increasing the jurisdictional rate base by about 14.6 million dollars,[4] which at the authorized 9.1% rate of return including

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[2] As pointed out above, attrition can result either from increases in rate base at a faster rate than revenues or increases in expenses at a faster rate than revenues, or, of course, both in combination. I will deal with the two effects seperately.

[3] Under traditional test year rate-making a weighted average rate base for plant-in-service would ordinarily be used in order to match test year revenues and expenses to the related investment.

[4]

Figures in Thousands			
Average rate base	632,610	End of period rate base	655,274
Less depreciation	143,628	Less depreciation	151,717
Net plant in service	488,982	Net plant in service	503,577

Difference: $14,575,000

provision for taxes, increases the revenue requirement by some 2.8 million dollars.

To express this in terms of the earlier theoretical discussion of test year rate-making, the Commission has accepted the view that the future relationship between revenues and rate base is more properly expressed by the relationship between test year revenues and the end-of-period plant in service rate base than that between test year revenues and the (lower) average plant in service. Or, put more simply, it will more likely require a greater investment in plant in service in the future to produce a dollar of revenues than it did, on average, in the test year. The relationship of D. C. sales of $190,054,000 is thus to an investment of $503,557,000 rather than $488,982,000, an increase from $2.57 in plant in service needed to produce a dollar of revenue to $2.65. Thus did the right hand give, but what of the left hand?

II. A.

There was a downward rate base adjustment in the materials and supplies account of 9.4 million dollars, with a concomitant reduction in the revenue requirement of 1.9 million dollars. The basis for this adjustment (which, it will be remembered, affects the critical relationship which test year rate-making is designed to produce) is the Commission's acceptance of the conclusion of its accounting witness that the average test year balance in the materials and supplies account ($66,296,000 ". . . . will be more representative of materials and supplies usage." than the conclusion of the Company's financial witness than an end-of-period balance of $88,177,000 would be more representative of the amount of inventory in the future.[4] The staff

[4] The difference between these figures, $21,881,000, is a system figure, the jurisdictional allocation process makes the revelant figure for the District of Columbia $9,389,000.

witness went on to support the averaging approach by noting that inventories fluctuate and the balance in the account at any particular time may be misleading. This proposition may be conceded. The question is not whether inventories fluctuate, but what figure they will fluctuate around during the future period when the rates established in this order will be in effect. It begs the question to discuss fluctuations, or to compare the appropriate treatment of this account for an electric utility with that of a gas utility, especially when in other contexts—such as treatment of compensating bank balances where the considerations are exactly the same for gas and electric utilities—we have reached differing results.

The error of the staff's position is seen to be more glaring when one considers that the principal item in the materials and supplies account is fuel, the price of which rose throughout 1974 to levels which have only just begun to level off. To predict the future, the value of the inventory at the end of the year 1974 would seem to be the one to pick rather than the 1974 average which includes fuel bought at 1973 prices, an era that is never to return.

But the Commission was not compelled to select between the conjecture of the company and the conjecture of the staff. We have accepted into the record monthly operating statements and balance sheets for the first eight months of 1975, and these were available to us as we deliberated upon this case. I had thought our purpose in accepting current financial reports was to permit us to make a better informed decision. Are we free to decline the opportunity to do so? I think not. Balance sheet figures for the materials and supplies account from January 1973

through August 1975 appear in footnote[6] together with running 12-month totals and monthly average balances. They demonstrate an average balance in the account for the first eight months of 1975 of slightly over $79 million,

[6]

POTOMAC ELECTRIC POWER COMPANY
Formal Case No. 630
Moving 12 Months Average Materials & Supplies
(Figures in Thousands)

	Month	Monthly Balance	12 Month Totals	12 Month Average
1973	Jan.	36,101,194		
	Feb.	35,768,162		
	Mar.	38,570,144		
	Apr.	39,213,497		
	May	40,709,193		
	June	39,566,422		
	July	38,882,160		
	Aug.	38,906,292		
	Sept.	41,779,374		
	Oct.	43,836,441		
	Nov.	47,438,741		
	Dec.	39,215,495	479,987,115	39,998,926
1974	Jan.	41,595,105	485,481,026	40,456,752
	Feb.	47,229,003	496,941,867	41,411,822
	Mar.	54,563,959	512,935,682	42,744,640
	Apr.	60,474,935	534,197,120	44,516,427
	May	67,048,383	560,536,310	46,711,359
	June	67,843,292	588,813,680	49,067,807
	July	70,736,490	620,668,010	51,722,334
	Aug.	74,288,950	656,050,668	54,670,889
	Sept.	81,066,707	695,338,001	57,944,833
	Oct.	81,194,291	732,695,851	61,057,988
	Nov.	82,871,245	768,128,355	64,010,696
	Dec.	88,073,144	816,986,004	68,082,167
1975	Jan.	88,390,036	863,780,935	71,981,745
	Feb.	88,422,992	904,974,924	75,414,577
	Mar.	85,660,167	936,071,132	78,005,928
	Apr.	84,461,874	960,058,071	80,004,839
	May	82,441,275	975,450,963	81,287,580
	June	77,942,234	985,549,405	82,129,117
	July	73,755,987	988,568,902	82,380,742
	Aug.			

a figure based on fact. I believe we are required to accept this figure, now that it is available, rather than the staff's $66 million or the company's $88 million in the absence of a showing that the $79 million average balance of 1975 to date is more unrepresentative of the future than $66 or $88 million

The classic argument to be made against this adjustment is that it violates the test year concept because it accepts data outside the test year to vary test year figures. This is fallacious. Test year data are always adjusted to reflect known changes and this data is certainly known. The purpose of adjusting the test year for known changes is to make it more useful as a predictive tool. To reject this opportunity to improve our inputs in the face of the evidence outlined above reflects not only a misunderstanding of the purpose and proper techniques for test year ratemaking, but is an act that is inconsistent with Commission's finding that this is an attrition-afflicted company since, contrary to the evidence, it establishes a revenue/rate base relationship that will produce a revenue shortfall. The majority has actually built attrition into the decision.

II. B.

Other downward rate base adjustments with which I disagree have also been made: removing $5.7 million[7] in survey and land acquisition costs from rate base, and reducing the rate base cash working capital account by $4.7 million as a result of denying rate base treatment to compensating bank balances. These are both issues over which reasonable people can differ, and I could accept the Commission decisions on these items if they did not represent reversals of the position taken by the Commission the last time it addressed these issues. As I read this and prior

[7] The D. C. allocable share of a system total of $10.6 million in these accounts.

cases, no new arguments have been advanced on either side of either proposition, and I am therefore unwilling to join the Commission in confessing the error of its earlier considered determination of these matters, even though I might have qualified my agreement with the Commission's decision in Case 596 to accept the survey and land acquisition item in rate base. This is said in order to make two points: first, I believe our decisions should demonstrate consistency and fidelity to our established policies in the absence of changed circumstances; second, disallowance of the $5.7 million dollar land and survey item has a downward revenue requirement effect of $1.2 million thereby further offsetting the attrition allowance.

II. C.

But where the Commission has erred, and erred most gravely, is in accepting the staff suggestion that only the average amount of construction work in progress (CWIP) be included in rate base.[8]

[8] The average balance allocable to the District of Columbia in the CWIP account during the test year was $104.3 million. At year end the District's share of the balance in the account was $131.8 million. The CWIP account is a "holding" account into which the rising investment is an element of utility plant is booked during the time it is under construction. Once construction is completed and the plant is put in service the related investment is transferred from the CWIP account to the plant-in-service account where it remains during the operating life of the plant. The balance in the CWIP account fluctuates during the year, rising as construction investment is booked into it and falling as plant goes into service and the related investment is transferred to the plant in service account. During the test year, there were no significant transfers out of the CWIP account but substantial construction costs were booked into it. For that reason the balance at year's end was significantly higher than the average balance in the account.

The Commission's order discussed the two approaches (CWIP and AFUDC in regulatory shorthand) that commissions use to insure that the carrying costs of the investment in utility plant while it is under construction are recovered. Under CWIP plant is carried in rate base while it is under construction; under AFUDC plant does not enter rate base until it goes in service. Under the CWIP approach today's rates must cover the carrying costs of the investment in plant under construction, whereas under the AFUDC approach these costs are not recognized and translated into rates until the plant goes into service. So, on a short-range view of the matter rate payers may be said to be better off when a Commission follows the AFUDC approach where the piper's recompense is deferred. A long-range view of the issue tends to lead to the conclusion that the CWIP approach favors ratepayers. In any event, both ratepayers and utilities seem to be adherents of the bird-in-hand school; utilities favor CWIP, which produces current cash flow, while ratepayers' representatives favor AFUDC, which leaves dollars in consumer's pockets today, leaving tomorrow to take care of itself. It was this verity that led People's Counsel and other intervenors to mount a vigorous effort to cause the Commission to reverse its long-standing policy and shift from CWIP to AFUDC. This was one of two big dollar issues in the case,[9] for if CWIP could be removed from an end-of-period rate base, rate base would decline by almost $132 million, and the revenue deficiency (if any remained) would be lower by almost $12 million—not small change, that.

It was onto this battlefield that the staff's accounting witness ventured with the recommendation that the Commission take the average of CWIP ($104.3 million) rather than the end-of-year figure ($131.8 million) in establishing the company's rate base.

[9] The other relates to the Fuel Adjustment Clause, and is discussed later.

The reason originally advanced in support of this proposal, that it would put CWIP treatment on a par with AFUDC, is flawed, as will be demonstrated. In fact, as cross-examination of the staff witness developed, the recommendation was offered with no other purpose than to point out to the Commission a path through the thorny thicket created by the challenge to inclusion of *any* CWIP in rate base.

As to including CWIP in rate base, the Commission has by this decision reaffirmed its policy of including it. That we were right to do so is best revealed by the nationwide movement of regulatory commissions to follow our lead and switch from AFUDC to CWIP even though it requires higher-than-otherwise rate increases at a time when inflation is exacting a heavy toll on consumers.

Where error has crept in is in acceptance of the average of CWIP in rate base. The staff witness argued that using an average CWIP balance would, ". . . . place the method employed by PEPCO [CWIP] on an equal basis with the AFUDC accounting convention. . . ." His point was that under the AFUDC approach the interest which is capitalized during construction and ultimately added to rate base to be amortized by the ratepayers is computed in a way that takes into account the fact that the balance in the construction account fluctuates from month to month. Under an end-of-year CWIP approach this refinement does not exist, and at first glance it appears that use of the AFUDC, weighted-average approach would in fact introduce an element of refinement and rationality to the CWIP convention. But this initially appealing conclusion is quickly rejected when one examines the underlying rationale which the AFUDC and CWIP techniques share—namely to provide reimbursement for the carrying costs of an investment in utility plant while it is under construction. As the majority opinion points out: the AFUDC plant enters rate base at its cost plus the sum of all interest necessary

to carry the investment during the construction period, which is not so with CWIP where recovery of a goodly portion of these carrying costs is never made. If the objective is to bring the result of applying one accounting technique (CWIP) into parity with the other (AFUDC) the task is to make adjustments that more nearly lead to total recovery of interest costs under CWIP, not the opposite, which is the effect of the Commission's order accepting this recommendation.

The point just made is both exotic and elusive; perhaps an example will help. PEPCO's Chalk Point #3 unit was under construction during 1974. Being under construction, the related investment was carried in the CWIP account, and, hence, was not recognized as plant-in-service and brought into rate base in this case. Nor, because CWIP was averaged, is the total investment in this plant brought into rate base under the CWIP rubric. In May 1975,* Chalk Point #3 was put into service and $160 million in related investment was transferred from the CWIP account to the plant-in-service account where it will not earn a return (as "plant-in-service") until the next rate case when the Commission will, as it must, include the whole $160 million in the plant-in-service rate base. Meanwhile, the portion of this investment that has been "averaged out" by the Commission's decision is not permitted to earn a return—and this result flows from Commission application of an accounting technique, which is claimed to bring about recovery of construction related interest costs!

Thus seen, it was manifestly unreasonable to use the lower, average CWIP balance in establishing rate base. In this connection, it bears mention that in a holding account such as CWIP an end-of-period balance is not necessarily higher or lower than an average balance. The balance rises incrementally as construction investments are made and falls as plant goes into service, so, while the end-of-period

* After the test year, but during pendency of the case.

balance on December 31, 1974 was higher than the average balance during the year, the opposite would have been the case if a June 30, 1975 test year were used because in May 1975 the Chalk Point plant (which raised the average balance in the account in the preceding months) was put in service thereby reducing the end-of-period balance in the CWIP account.

The timing of when a plant goes into service is independent of rate case filings or selections of what 12-month period shall constitute the test year—or should be. Query, whether the Commission would have adopted an average CWIP balance if a June 30, 1975 test year had been used in this case, when to do so would have meant a higher total rate base.

If one concedes our agency expertise, the CWIP-averaging decision must be deemed to be an informed decision. Since it is clearly wrong, and the circumstances point to only one other explanation for it—namely an expediency perpetrated in the interest of holding down rates it must be seen as arbitrary and is, on that basis, probably reversible error.

One obvious way to deal with this matter under test year rate-making was to adjust plant-in-service upwards and CWIP downwards for the known change that occurred when Chalk Point #3 went into service.

I discuss the CWIP issue in the rate base attrition section of this opinion because this Commission includes CWIP in rate base, and therefore the figure selected as representative of CWIP affects the critical revenue/expense/rate base relationship.

The effect of using average CWIP in the rate base under the circumstances of this case is to reduce the D. C. rate base by $27.5 million with a resultant decrease in the revenue requirement of some $5.5 million, an amount that

more than offsets the attrition allowance granted by permitting an end-of-period rate base for plant in service. This of course is directly contradictory to the Commission's finding of attrition.

II. D.

This is probably the point at which to compare the rate base adjustments made in this case with those made in our last case involving the Company, Case 596 decided about two years ago. In that case, upon a finding of attrition, an end-of-year rate base was selected. The Commission then gave end-of-year treatment to all items included in rate base, not only plant in service as in this case. In this case two significant components of rate base, construction work in progress, and materials and supplies have been averaged, and the survey and land item has been disallowed in its entirety. Placing the rate base in this case on the same basis as Case 596 would have resulted in a rate base of $692,593,000 and not $650,090,000 as found by the Commission. To equate the two, the following should be added to the Commission's D. C. rate base:

Land Surveys	$ 5,659,000
CWIP	27,455,000
Materials and Supplies	9,389,000
Total	$ 42,503,000

The comparison between the last case and this one is offered to raise the question whether the rate base attrition being felt by the Company today is so different from that felt in 1973 as to call for different treatment by the Commission. This Commission has never dealt with the attrition issue in quantitative terms although techniques to measurement of the attrition effect and tailor a measured response are available. I would like to see us move in this direction.

III

Attrition, it will be remembered, takes two forms, expense attrition and rate base attrition, each brought about by increases in those components at a faster rate than revenues. They may combine in a cumulative way or in an offsetting way. The prior discussion relates principally to rate base attrition.

As regards expense attrition, I am generally in accord with the way this Commission has dealt with the energy utilities under our jurisdiction. This has been by acceptance of carefully monitored, automatic adjustments to rates to reflect fluctuations in fuel and purchased gas costs. These are the major expense items for energy utilities, and recent history has revealed them to be the least predictable. Establishing a fixed fuel expense/revenue relationship under test year rate-making would have been fallacious and events have demonstrated the correctness of our decision not to attempt it. The remaining expense items have historically been more controllable and stable than fuel and hence more amenable to the test year rate-making formulation. By adjusting for the post-test year wage increase in this case we have moved toward establishing the appropriate relationship of wage expense to revenues and maintain the validity of the test year approach to that item, especially if one accepts the company's claim that employment levels are as low as is prudent with safe and reliable operations and that new and replacement hiring is carefully controlled. It may be that the future will bring sufficient volatility to other major expense categories—wages, taxes, and supplies particularly—as to cause the Commission to consider automatic adjustments in rates to deal with changes in expense other than fuel. That day should not come before the Commission is equipped to measure the operating and financial efficiency of the utilities, however. The quest for these competencies has begun among thoughtful and forward-

looking regulatory bodies and we should associate ourselves with it.

Returning to consideration of the expense attrition issue as it developed in this case one finds that it centered around the automatic fuel adjustment clause. The Company proposed a comprehensive revision of the clause, the principal change begin a proposal to account for the financial results of the Company's transactions on the PJM interchange grid in a manner that would reflect these financial results in the fuel surcharge element of rates rather than in the base rate as they are now. This was the second issue of major financial moment in the case. The Commission has rejected the Company's proposal; I would have accepted it with modification which I will outline below.

Since the majority opinion does not discuss the issue except in the broadest terms and purports to decide it upon some unexplained conception of fairness, I think an explanation of the issue might be in order for those who are disposed to examine the consequences of the Commission's decision on this point.

PEPCO buys and sells power and energy over the PJM grid, an electrical interconnection among several utilities in the mid-Atlantic area. The most important transations on this grid are the so-called "economy energy" transactions in which, to oversimplify a little bit, utilities buy and sell electricity in order to achieve the lowest possible cost of sales. Transactions are made at a price midway between the (lower) cost of generation at the selling utility and the (higher) cost of generation at the purchasing utility. Thus, if the selling utility's current cost of generation is 2.0¢ per kilowatt-hour (2.0¢/kwh) and the purchasing utility's current cost is 3.0¢/kwh the transaction is made at 2.5¢/kwh, thereby providing energy to the purchasing company at a cost 0.5¢/kwh lower than it would incur if it generated it itself, and offering a sales incentive of 0.5¢ to the selling company.

For reasons related to mix of generating plant and asynchronization of system peaks of the utilities connected to PJM, PEPCO has historically sold more electricity each year on the grid than it has bought, although there are times when it is a purchaser. These transactions are not insignificant; during the 1974 test year PEPCO sold 4,823,553,000 kwh of energy more than it bought (by contrast, I used about 6,100 kwh of energy in my house during the test year). These sales produced a "profit" of about $41.5 million, a figure derived as follows: 4,823,553,000 kwh sold at an average price of 3.31¢/khw =

	$111,481,000
less cost of generation at 1.45¢/kwh	69,941,000
	$ 41,540,000

The word profit above is placed in quotation marks because these net proceeds do not emerge as profits on the accounting statements. Under the accounting treatment ordained by the Commission the gross margin earned on interchange transactions is applied as an offset against expenses in the test year calculations used to establish the revenue requirement, which, in turn, determines the level of rates.

At this point I again remind the readers of the purpose of test year rate-making: to predict financial relationships expected to obtain in the future period when rates will be in effect. But—as should be obvious—there is no relationship whatsoever between PEPCO's net "profit" on PJM transactions and the jurisdictional operating expenses against which they are offset. PEPCO's margin of revenues over expenses earned on the PJM is related to the volume of business done in PJM and the prices at which this business is transacted. If PEPCO's PJM margins move in equilibrium with the changes in revenue/expense/rate base presumed by the test year then no harm is done by treating them as we do. But if not, the validity of the

test year as a predictive device is diminished and with it the integrity of today's order.

There can, of course, be no demonstration in advance that PEPCO's PJM margins will move with the other elsements of the test year relativity equation. *To the contrary.* The uncontradicted evidence in this case is that PEPCO's total PJM margin will decline in the future both in terms of volumes of business transacted (other PJM companies have added generating capacity that will make them more self-sufficient) and in the margin earned on the transactions made (much of this new capacity is efficient, low-cost generation which will narrow the difference in the cost of generation between PEPCO and the purchasing utility). *E.g.,* if the purchaser's generating cost is not 3¢ but 2.4¢/kwh and the seller's cost is 2.0¢/kwh the transaction is at 2.2¢/kwh which produces a margin to the seller of .2¢/kwh; so, even if the same volume is transacted the profit will be only 40% of what it would have been at a 3.0¢/kwh purchaser's cost.

Let us now consider the effect of this on test year rate-making. On the basis of the test year data used in this case, PEPCO's D. C. expenses are understated by $17.3 million,[10] which represents the amount by which test year expenses were reduced because of the offset related to PJM transactions. *I.e.,* absent the PJM offset, PEPCO's operating expenses would be $160.5 million and not $143.2 million as shown on Attachment A, page 2. This expense figure relates to $190 million in D. C. revenues, and is the significant figure in establishing the test year revenue/expense relationship. If D. C. revenues rise 5% next year and expenses also rise 5% the revenue/expense relationship established by the text year will be maintained and all will be well. But it must be remembered that the expense figure is derived after deduction of the PJM "profit." In short,

[10] The D. C. share of the $41.5 million total.

operating expenses are as low as they are because the PJM net is as high as it is. If PJM net declines, the offset to expenses declines and stated expenses rise on that account alone, thereby making it impossible for the utility to achieve the return authorized by the Commission.

As I mention above, PJM revenues do not vary in relationship to PEPCO's revenues, expenses or rate base. It is, therefore, conceptually inappropriate to incorporate the PJM experience into test year rate-making. This theoretical problem is not significant if it can be shown that its effect will be neutral or negligible in the future period during which rates will be in effect. The difficulty in this case is that this has not been done. Not only has it not been done, but the 1975 operating results accepted into the record in this case reveal that the D. C. share of PJM offsets to date for 1975 is lower, as predicted. In fact it is only about $4.1 million as compared with $11.7 million for the comparable 1974 period used in the test year. This $7.6 million dollar difference translates directly into rates. Is it any wonder that this issue was hard fought?

PEPCO's proposal was to remove the accounting for PJM transactions from the test year operating expense calculation, and, instead apply the PJM profits as a direct offset to the fuel adjustment surcharge which is added on to base rates. This would eliminate the distorting effect of the volatile PJM offset on the test year rate-making process just as the Commission has done with fuel costs. I believe that if there had not been immediate and significant consequences for rates, the Commission would have accepted this change because of its theoretical soundness and its contribution to an enduring order in this case.[11] On that basis, I would have had the Commission's decision on

[11] The Company deserves no kudos for waiting to make this proposal until the presumed political consequences attendant on its acceptance overwhelmed the Commission's will to consider it on it's merits.

this issue go the other way, not only because I subscribe to the reasoning advanced earlier, but because I feel that the "fairness" the Commission extends to ratepayers by its decision need extend no farther than insuring that they get 100% of the benefit of profits earned by PEPCO on the PJM—as they would if these profits are offset against the fuel adjustment surcharge. Moreover, as I hope a reading of the foregoing has demonstrated, the Commission by denying that future PJM margins will be lower in the face of uncontradicted testimony, and actual evidence of operations which proves it, has brought about expense attrition and not countered it, which is our obligation. The majority's reliance on the argument that moving PJM accounting to the fuel adjustment charge removes the profit incentive to earn as much as possible from interchange transactions is misplaced; treatment of interchange margins can be accounted for in a manner that will retain the financial incentive to maximize the gross margin on this business.

IV

By following the traditional test-year rate-making approach in this case without making an appropriate allowance for attrition, the Commission assumes that the distorted revenue/expense/rate base relationship in which this order is rooted will apply in 1976 and beyond, so long as this order is in effect. At the same time, protestations of bewilderment are entered at the fact that this is this company's fourth rate case in six years. The reason is obvious: increases in expense and rate base outpaced the increases in revenue after the 1970, 1972 and 1973 rate cases, as they will do after the 1975 case in the absence of an order that recognizes that fact and allow for it. Unhappily, the Commission has done no more in this case than to set the stage for lamentations over the company's fifth rate request, which is sure to come in the near future. For, if ever a record demonstrated attrition, this one does. If ever a record called for realistic steps to deal with attrition, this

one does. If there was ever a demonstration of the failure of revenue growth to keep up with the growth of expenses and investment, it appears in the record spread before the Commission in this case, where there is data not only for the test year but also for the nine months following—data which the Commission accepted into the record, I had thought, for the purpose of reaching a decision that took account of the real world as it was revealed to us by the operating results of the company during the pendency of the case.

V

If there is strength in this order it is in its rate design aspects, where first steps are taken in what must be an evolutionary process to restructure PEPCO's rates using costs as the primary basis for rate making while taking account of the potential of rates to alter demand so as to achieve whatever improvement in load factor may be brought about by economically justificable pricing techniques. Our order for a cost of service study, which a Commission appointed agent will help design and monitor, is a first step, and our order to the company to poise itself to implement a time-of-day rate for the 750 large customers who use 54% of the energy is step two.[12] In the interest of creating customer classes of more homogeneous characteristics we also direct the company to identify the apartment customers in its commercial class with a view to ascertaining their load characteristics and perhaps incorporating apartments into the residential class. Two possible deterrents exist: first, many apartment structures are partly commercial and it may be infeasible to split the electric service in the building; second, some apartment dwellers may now actually be enjoying rates that are lower, not

[12] Although this order is out of phase in presuming that the company can recommend cost-based time-of-day rates before the cost study is completed. Hopefully, this will be adjusted.

higher, than residential rates if their dwelling structure is an efficiently managed, large General Service schedule customer.

I have pointed out earlier the conceptual fallacy of including net interchange transactions as an offset to fuel expenses within the test-year concept and the attrition-exacerbating effect of the Commission's failure to move this item to the FAC. It also seems to me that there are some other aspects of the fuel adjustment clause that should have been dealt with.

I believe that if we did nothing else we should have put the Fuel Adjustment Clause FAC on a "zero basis" (i.e. collecting the entire cost of fuel in the FAC) in order to eliminate the confusion engendered by having part of the fuel costs in the base rate and part in the Fuel Adjustment Clause.[13] We all remember the distortions introduced into the debate on the fuel clause last year when the Fuel Adjustment Charge rose at a faster rate than the rise in the cost of fuel itself. This problem was the direct result of having part of the fuel costs hidden in the base rate, and it led to massive public confusion. No party to the case disagreed with moving to a zero-based FAC. Moreover, it would be a step in the direction of 3-part rates favored by the Commission since it would establish an energy component to rates.

As to the company's proposal to move the Fuel Adjustment Clause charges to an estimated basis in order to match expenses and revenues, I believe the Commission was correct to retain the present procedure, which involves a collection lag, rather than adopt the company's proposal to use estimated costs and then adjust them after the fact.

[13] Under the present rate structure, continued by the Commission in this case, the charge for each kilowatt hour of electricity sold includes 6/10¢ for fuel. Only the fuel cost in excess of .6¢/kwh is collected in the fuel adjustment surcharge.

Keeping a short lag in the billing is a financial lever that induces the company to minimize its fuel cost in order that its carrying charges are minimized. Moreover, keeping a lag will eliminate the problem of collecting almost 13 million dollars in deferred fuel costs from the rate payers, which would be necessary if the company's proposal to accelerate the billing had been accepted.

Finally, the issue was raised as to whether the slightly lower multiplier for high voltage customers should be retained in the FAC to account for electrical efficiency of the system. I believe it should be because the company has given no reason for abandoning it other than "simplification".

The Commission's determination that there shall be no rate increase at all for residential rates up to 450 kwh/month is utterly baffling to me. On October 30—less than two weeks ago—the Commission presented unanimous testimony to the D.C. Council in opposition to a lifeline rate bill. Yet, on November 11 we ordered implementation of lifeline rates. As everyone knows lifeline rates bestow indiscriminately a subsidy that is generally agreed to be merited only by the poor. Lifeline rates are the antithesis of cost-causation as the basis for rate-making. This order is also subject to the criticism that income redistribution is a function appropriately confided to legislatures using taxes as the vehicle to accomplish the task—not a result to be accomplished by regulatory bodies using utility rates as a device. A former Chairman of this Commission,[14] while recognizing the existence of conscious cross-subsidization in utility rates sounded a note of caution:

> "All in all, therefore, there is nothing wrong in leaving to regulation the power to make a judgment that

[14] George A. Avery, Esquire. "Social and Economic Factors Underlying Current Trends in Rate Design", *Proceedings of the Symposium on Rate Design Problems of Regulated Industries*, p.59, Foster Associates, Inc., 1975.

> the economically disadvantaged should be protected in some measure from the increasing cost of Electricity. The decision as to how that judgment should be exercised in particular cases must be left to those charged with the responsibility for fixing rates on the basis of record facts.
>
> "However, this latter observation raises another point which merits some consideration. While the regulatory process can be used to effect income redistribution, there is some question whether the social judgments involved should be made by appointed officials with a relatively narrow scope of responsibility or should be left to elected representatives directly answerable to the people. *The question is particularly acute where the appointed regulator has been given no legislative guidance on the issue involved*"[15] (emphasis mine).

Chairman Avery there describes the situation in this jurisdiction, where lifeline rate legislation is now pending. I for one do not have the temerity to anticipate the outcome of the legislative process, and would not have tried to do so in this order.

The limits of the "reasonable, just and nondiscriminatory" standard upon our discretion were tested in the last rate case involving this company, and a similar order as to residential rates was upheld.[16] Nevertheless, I am concerned that this decision may have carried the degree of subsidization of residential customers beyond the limits of discretion we enjoy under our statute. Moreover, the subsidy involved, about $1.8 million as I calculate it, must be borne in part by apartment-house dwellers. I believe our consumer constituency is broader than the single-family residential class.

[15] Ibid. p. 71.

[16] *Apartment House Council* vs. *PSC* (D.C.C.A., 1975).

I accept the flattening of summer residential rates as sound ratemaking, but the combination of no increase and flat rates for the winter residential rate and flat-rating the low voltage commercial schedule jeopardizes achievement of the overall revenue goal by shifting recovery of costs to tailblocks, a danger pointed out by the Commission's erudite witness on rate structures, Mr. James Lim.

VI

It cannot be demonstrated that the rate of return found reasonable by the Commission in this case fails the statutory test, and I support it even though it is in the low range, because I am not convinced that the ability to attract capital (one of PEPCO's problems) bears any necessary relationship to the company's *authorized* rate of return in today's investment climate. Investors, rather, evaluate the expected actual earnings and the quality of those earnings. Therefore, my concern was that in this case we would adhere to our CWIP policy which produces a flow of green dollars and not bookkeeping entries, and that we would squarely address the question of what is required to counteract attrition and give the company an opportunity to earn the return we authorized. If we had addressed and dealt with that latter question I think a rate of return on equity as low as what is authorized in this case could have been justified. For me the question is whether, attrition having been found, the Commission is required to forecast it, even on the basis of historical projections, and relate its return allowance to a quantitative finding. This we did not do in this case, partly because of the failure of the company to develop an adequate record on the subject.

To sum up, the Commission's order posits an economic enviroment reminiscent of the early 1960's. In failing to acknowledge and deal with the fact that operating and capital requirements per unit of sales have risen, and continue to rise, faster than revenues the Commission has

taken a step that can only bring regulation in the District of Columbia into disrepute among the fairminded and knowledgeable.

At a minimum, the rate base should have been established at $693 million; and the credits for PJM interchange transactions should have been made applicable as offsets to the fuel adjustment surcharge.

Appendix B

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA

1625 I Street, N. W., Washington, D. C. 20006

Order No. 5759

January 12, 1976

IN THE MATTER OF

Application of POTOMAC ELECTRIC POWER COMPANY for an increase in its retail rates for the sale of electric energy	))))	Formal Case No. 630

ORDER

BEFORE THE COMMISSION: Ruth Hankins-Nesbitt, Chairperson;
H. Mason Neely, Vice Chairman; and
William R. Stratton, Commissioner

The Commission has before it for consideration a Petition For Reconsideration, an Application for Reconsideration and Rehearing, and an Application for Reconsideration, all filed on December 12, 1975, by Department of Highways and Traffic, District of Columbia Government (Highways and Traffic); General Services Administration (GSA); and Potomac Electric Power Company, (PEPCO),

respectively. The GSA Application was filed before the close of business but after the 3 o'clock p.m. deadline provided under Rule 14.5 of our Rules. Nevertheless we will address GSA'a Application in this Order.

Each pleading seeks reconsideration and modification of the Commission's November 12, 1975 Final Opinion and Order in Formal Case No. 630. Each pleading also shares the flaw of being essentially a reargument of points previously advanced in Formal Case No. 630, thoroughly considered by the Commission, but nevertheless rejected in our Final Opinion and Order for the reasons therein stated.[1] The purpose of a petition for reconsideration is not well served by rearguing previously made contentions. Rather than dismiss the pleadings on this ground, however, we will undertake consideration of these points again with the thought that given the opportunity, we might express our views and our rationale with a degree of clarity that will leave no room for doubt as to what we decided and why.

Turning first to the pleading filed by Highways and Traffic, we note that Highways and Traffic remains convinced of the correctness of its view that street lighting facilities should be depreciated on a component basis rather than on a composite basis. It finds support for its view in its contention that street lighting facilities are substantively distinguishable from other PEPCO facilities or equipment in that street lighting facilities, according to Highway's and Traffic, have no relation to the supply of electricity.

[1] The GSA and PEPCO applications are opposed by People's Counsel and denial urged basically on the ground of repetition of arguments properly ruled on in the Final Opinion and Order. People's Counsel also suggests deferral of ruling on the "all-electric" rate issue, a matter which we will address at a later point in this order.

The short answer to this contention is that it is simply without foundation. The asserted fundamental distinction between investment in street lighting equipment and investment in all other types of property is not established by recitation of the words. Carried to its extreme, this contention would also require use of a component depreciation rate for PEPCO's own lighting facilities and equipment in its office building, its generating stations, and its substations and elsewhere on PEPCO's own property. It could also be said with equal logic that PEPCO's vehicles have no relation to the supply of electricity, and the relationship of poles supporting lighting fixtures and poles supporting wires to the supply of electricity may be equally nebulous, although the poles themselves may be identical.

Differences in types of property are indeed recognized by component depreciation rates and different types of property may indeed have different relationships to the supplying of electricity. It would be inconceivable for us to engage in the accounting monstrosity of using component rates for all types of utility property and for all customers. And as we have said in prior orders, we see no reason to depart from the uniform system of accounts for the apparent benefit of one customer.

Highways and Traffic also renews its contention that PEPCO has made a double allocation of investment costs for distribution equipment used in conjunction with street lighting facilities. We understand the Department to agree that distribution equipment used in conjunction with street lighting facilities is properly included in the development of rate base for street lighting energy charges. Its contention appears to be that this same investment also forms part of the "rate base" used in developing fixed and operating and maintenance charges. We have with great diligence attempted to follow this contention, and indeed have conducted our own independent review of the record on the "double allocation" point. Neither exercise persuades us that Highways and Traffic is correct. The problem here appears to arise from a somewhat imprecise use of the term "distribution plant" or "distribution equipment." As we read the record, distribution plant used

wholly and solely for street lighting, including service conductors, is assigned directly to street lighting service. Other distribution plant used in common to serve street lighting and other customers, is allocated among the several classes of customers. Viewed in this perspective, we find no double allocation or double counting, and therefore remain unpersuaded by the Department's contention.

As to the Highways and Traffic's contention that street lighting rates should be fixed on some basis other than lumen output—presumably "cost"—we have somewhat the same difficulty that we encountered in considering the component depreciation contention. It is often been said that utility rate making is an art, not a science. Yet it appears to be Highways and Traffic's position that exact costs should be determined for each type of lamp used in street lighting service and rates fixed to precisely correspond to those costs.

There is indeed a surface inconsistency between a higher operating and maintenance charge for a unit requiring less operation and maintenance (*e.g.*, mercury and vapor and high pressure sodiaum), and, conversely, lower operating and maintenance charges for units requiring more operation and maintenance (*e.g.*, incandescent lamps). Whether the two charges might precisely offset each other is not clear on this record. What is clear, however, is that there is a total cost involved in the street lighting operation and maintenance function, a cost which is recovered under the current rate schedules by the use of a lumen output formula. While it may be possible, in theory at least, to determine operating and maintenance charges for types of street lamps under a different formula or with greater individual accuracy than has been done under the proposed schedules, we are not persuaded that separate costs can be or need be measured with such fragmented precision. We do not find the total charge unjust and unreasonable; and therefore we will not require a change in the methodology of its calculation at this time. Parenthetically, it was in this context that our final opinion and order suggested

that several of Highways and Traffic's contentions would have no measurable effect on street lighting rate structures, not the "double counting" contention with which the petition for reconsideration erroneously associates our order.

In addition to these major points, the Highways and Traffic petition raises a number of other issues. With regard to the contention that the differential in operating and maintenance charges between underground lighting and overhead systems is unjustified, we find no basis in the record on which to conclude that no differential is warranted, nor do we find record support for the Highways and Traffic contention that the differential is too great.

We view the contention that an adjustment in street lighting service rates should be made to compensate for alleged overcharges over the past ten-year period as a renewal of the Highways and Traffic request for reparations which we denied in our order dismissing its complaint. We adhere to the views expressed in that order, and we perceive no legal basis for adjusting future rates either upward or downward to equalize rates that may have been too low or too high in past periods.

Highways and Traffic also complains that "PEPCO's proposed rate structure provides for no penalty provisions" in the event that PEPCO fails to maintain street lighting facilities. Here we must point out again, as was frequently emphasized on the record in this case, that street lighting maintenance provisions are a part of the PEPCO tariffs as filed with, or in this case prescribed, by this Commi-sion. They are neither PEPCO proposals nor a PEPCO statement. In our judgment, adequate remedies exist for violations of tariff provisions, and the inclusion in a tariff of a penalty for its violation is wholly unnecessary.

Finally, Highways and Traffic complains that there is no tariff provision that the fixed charge will not be applicable to lighting facilities and equipment installed and paid

for by the Department. Our review of the record on this point indicates to us that it is quite clear that the fixed charge contained in PEPCO's tariff will not be applicable to lighting facilities and equipment installed and paid for by the Department. We see no need for requiring a statement in the tariff itself that no charge will be made.

The principal point raised by the GSA Application for Reconsideration and Rehearing is that the rate schedules called for by Order No. 5739 are unjust, unlawful and discriminatory. In particular, GSA contends that these rate schedules require commercial low voltage and high voltage customers to subsidize residential consumption. GSA does recognize that under rate schedules existing prior to Order No. 5739, both low voltage and high voltage customers provided a rate of return higher than that realized from residential service. Its stated concern is not that all classes of service should produce an identical return, but that the existing spread in customer class returns would be increased under the rate schedule proposed by PEPCO.

Our decision in Order No. 5739 to allow PEPCO only approximately half of its requested revenue increase does substantially reduce, of course, the spread between class rates of return indicated in the PEPCO rate proposals. According to GSA, however, the spread, although undefined, remains too great; and the alleged discriminatory nature of the rates is aggravated by our decision to exclude from rate increases the first 450 kilowatt hours of residential monthly consumption.

On this latter point, we would note in passing that the revenue effect of excluding the first 450 kilowatt hours of residential usage results in the absorption by high usage residential customers and other customer classes of approximately $200,000 a month. The absorption of this amount in PEPCO's slightly over $18,000,000 monthly

revenues is obviously somewhat less than significant. And while GSA asserts that the first 450 kilowatt hours of residential usage is not compensatory, it cites and we find no record support for that assertion.

Despite the vigor of the GSA argument, we remain convinced that the increased demand and energy requirements which have been and remain responsible for increases in PEPCO's plant investment at higher unit costs were not and are not attributable to the basic use residential customer. Although the rate increases allowed PEPCO in this proceeding do indeed widen to some degree the spread in class rates of return, we see no reason why the increase in cost incurred by PEPCO should be placed, by way of an even distribution of these increased costs, on those customers not responsible for the increases.

GSA is also critical of our requirement for a study of possible rate discrimination against residential apartment tenants. We believe that this complaint must be summarily rejected for the reason, among others, that it is clearly within the Commission's discretion to call for a study of any regulatory problem which concerns it. We simply fail to see how merely ordering a study can be called discrimination.

Similarly, we are not persuaded by GSA's argument that we have arbitarily singled out one class of customer for peak load pricing. What we have done is expressed agreement with the concept of peak load, time of day rates and have scheduled the initial step in implementing that concept in the area where implementation can be accomplished most economically and efficiently. As our order clearly indicates, it is our intention that PEPCO continue its existing studies in the area of peak load pricing and such additional studies as we will by subsequent order require of PEPCO. It may indeed be possible that adequate

data supporting peak load pricing for all customer classes would be available within the one year period set for conversion of large power users to peak period or time of day rates. If it is not, we see no reason why the concept must be applied either to all customers at the same time or to none. Moreover, in this instance, as well as in the study of apartment house use, it appears to us that GSA's concerns may be premature. GSA and any other customer will have the opportunity, of course, to give the Commission the benefits of its views as studies are completed and rate proposals submitted to the Commission.

Finally, we are constrained to assure GSA that the Commission neither misinterpreted, nor misunderstood, nor miscontrued, nor overlooked GSA's presentation in this case. We did and do assume GSA's interest to be that of the Federal Government as a customer of PEPCO. In furtherance of that interest, as GAS saw it, it strongly advocated cost related rates and urged that the government as a customer made no greater contribution to peak demand or usage than other customers or classes of customers; and that in fact the government's load factor was better than that of other customers. Our conclusions with regard to rate structure simply differed from GSA's contentions. It was and is our view that although cost is a most significant factor, rates need not be and should not be based on costs alone. Other factors must be and have been considered in our decision here, including peak causation, load diversity, historical rate patterns, and relative contribution to total revenues. To have accepted the GSA approach would have required us to ignore, for example, the latter two factors, and to have imposed about a 50% increase on residential users, a class of customers that provides only about 17% of total revenue. Low and high voltage commercial customers, on the other hand, classes that account for almost 80% of revenues, would under the GSA approach bear an increase of about 14%. To have

chosen that course would have been, in our judgment, an unconscionable and flagrant abuse of our discretion.

We turn next to the application for PEPCO for reconsideration of Order No. 5739. The PEPCO pleading, perhaps to a greater degree than the pleadings filed by Highways and Traffic and GSA, strikes us as essentially a reargument of the same contentions put before us on the record and on brief prior to our Order No. 5739. In essence, the PEPCO pleading again finds "attrition" and asserts that the Commission, in various ways, failed to allow enough of a revenue increase to counteract "attrition".

It is undisputed that the data presented for the record by PEPCO covering operations in calendar year 1974 and the period through June 30, 1975 indicate a continuing decline in PEPCO's earnings. This fact was fully considered by the Commission in arriving at its decision in its case, even though the decision was indeed based on a 1974 calendar year test period. In this context, we find the PEPCO application troublesome in two respects: First, as we understood the testimony of PEPCO's witnesses it was not PEPCO's position that operating results for the 12 months ended June 30, 1975 should be used as a test period in this case; second, we were not and are not persuaded that the continuing decline in earnings experienced by PEPCO in the first 6 months of 1975 can properly be attributed to that elusive factor known as "attrition". As we have previously stated on several occasions, we think it neither proper not accurate to attribute all declines in earnings to attrition. Moreover, in this case as well as in all regulatory proceedings the introduction of new evidence must end at some point. In short, were we to adopt a moving test year, a proposition that would seem implicit in PEPCO's Application for Reconsideration, the necessary scrutiny of each succeeding month's operating results would both prolong regulatory proceedings beyond endur-

ance and effectively postpone indefinitely the date on which PEPCO might receive any rate relief determined to be necessary or appropriate.

The specific assignments of error that are included in PEPCO's application, *e.g.*, our use of average balances in construction work in progress and materials and supplies, the exclusion of compensating bank balances and preliminary survey expense, and adherence to the current fuel adjustment charge, have already been fully considered in Order No. 5739. For the reasons recited in that order we find PEPCO's assignments of error on these points to be without merit.

We do find one point raised by PEPCO persuasive. Our order No. 5739 provided that no new customers would be permitted under the all-electric residential schedule. In so ordering, we had not considered the plight of would-be all-electric customers whose choice had been made prior to our order and whose residences had been planned, or contracted for, or were already in the contruction process. To accommodate those in that category, we will modify Order No. 5739 to provide a grace period, and permit new all-electric residential customers to avail themselves of the all-electric schedule for service begun on or before January 1, 1977.

As indicated above, we have carefully and thoroughly considered each of the pleadings urging reconsideration of Order No. 5739. We remain convinced that the results reached in that order are fair and reasonable, and represent the necessary balancing of the interest of PEPCO and its customers. We therefore affirm Order No. 5739, as modified herein in respect of all-electric residential customers, and deny the petitions for reconsideration.

In addition to the timely filed Highways and Traffic, GSA, and PEPCO pleadings, the Commission has also received a motion for leave to file a petition for reconsi-

deration, dated December 31, 1975, on behalf of Intervenors Washington Public Interest Organization and Dr. and Mrs. Henry Kalmus (WPIO). The motion was opposed by PEPCO on the ground that the 30 day period for filing petitions for reconsideration is statutory and therefore may not be extended or waived by the Commission.

As we read the statute and the cases, the Commission has no discretion in this matter. The filing period is prescribed by statute, not by Commission rule, and the WPIO motion must therefore be denied.

THEREFORE, IT IS ORDERED:

That the Applications and Petitions filed seeking reconsideration of Order No. 5739 be and are hereby denied.

A TRUE COPY:

By the Commission:

/s/ RUTH HANKINS-NESBITT
Ruth Hankins-Nesbitt
Chairperson

APPENDIX C

DISTRICT OF COLUMBIA COURT OF APPEALS

No. 10490

POTOMAC ELECTRIC POWER CO., PETITIONER,

v.

PUBLIC SERVICE COMMISSION OF
THE DISTRICT OF COLUMBIA, RESPONDENT,

PEOPLE'S COUNSEL, INTERVENOR.

Petition of Appeal of an Opinion and
Order of the Public Service Commission
of the District of Columbia

(Argued April 30, 1976 Decided November 9, 1977)

Edward A. Caine, with whom *Alan G. Kirk, II*, *Susan H. Power*, and *Carl D. Hobelman* were on the brief, for petitioner.

Linus H. Deeny, Assistant Corporation Counsel when briefs were filed and the case was argued, with whom *John R. Risher, Jr.*, Corporation Counsel, and *Louis P. Robbins*, Principal Deputy Corporation Counsel, were on the brief, for respondent.

Annice M. Wagner, People's Counsel when briefs were filed and the case was argued, for intervenor.

Before NEBEKER, YEAGLEY, and HARRIS, *Associate Judges*.

Opinion for the Court by *Associate Judge* HARRIS.

Dissenting opinion by *Associate Judge* YEAGLEY at p. 49.

Concurring opinion by *Associate Judge* NEBEKER at p. 84.

HARRIS, *Associate Judge*: Potomac Electric Power Company (Pepco) has petitioned this court pursuant to D.C. Code 1973, § 43-705, to set aside as confiscatory the rates prescribed by the Public Service Commission of the District of Columbia (the Commission) for its retail sales of electric energy to District of Columbia customers. The rate rulings were established by a two-to-one vote of the Commission in Order No. 5739 on November 12, 1975. *Re Potomac Electric Power Co.*, 11 P.U.R.4th 215 (PSC D.C. 1975). Pepco's request for reconsideration was denied by Order No. 5759 dated January 12, 1976. Concluding that the Commission arbitrarily and unreasonably set the company's rate base at a level insufficient to allow Pepco a reasonable opportunity to earn the rate of return which the Commission itself found to be just and necessary, we vacate the orders appealed from and remand for further proceedings.

I. PROCEDURAL HISTORY

On December 20, 1974, Pepco filed an application for an increase in its retail rates. The application was based upon a calendar 1974 test year, and sought an increase of approximately $50,832,000 in gross operating revenues annually.[1] Such additional revenues theoretically

[1] Pepco's original filing was predicated on an eight-month actual and four-month forecast basis. It later was updated to encompass actual data for all 12 months of 1974 and, prior to the close of the record, for the first six months of 1975.

would have resulted in a 9.75% rate of return on the company's 1974 year-end rate base. Following a series of postponements and delays, a prehearing conference was held on May 6, 1975. As an outgrowth of that conference, the Commission granted intervention to 13 parties, one of whom, People's Counsel, is an intervenor on appeal.[2] Twenty-two days of public hearings ultimately were held from June 4 through July 24, 1975. On July 18, 1975, Pepco filed with its rebuttal testimony an updated test period reflecting actual operating figures for the 12 months ended June 30, 1975. Thereafter, further cross-examination was conducted, briefs were filed, and oral argument was heard by the Commission on September 3, 1975.

After filing its original application, Pepco twice sought interim rate increases (by applications dated March 12 and July 3, 1975) based upon (1) the adverse impact of accelerating attrition,[3] and (2) the length of time which obviously would elapse before the Commission's

[2] The Office of People's Counsel was established by Congress on January 2, 1975. *See* D.C. Code 1977 Supp., § 43-205. The early delay in this case was occasioned in part by the Commission's desire to obtain the participation of People's Counsel, which office had not yet been established during the first few months of the proceedings.

[3] Attrition may be defined as the inability of a utility to earn its authorized rate of return due to the fact that its investment in rate base and/or its operating expenses are rising faster than revenues. *Telephone Users Ass'n v. PSC*, D.C.App., 304 A.2d 293, 298 (1973), *cert. denied*, 415 U.S. 933 (1974). The importance of attrition to a proper determination of rates is discussed in section V of this opinion, *infra*.

final decision. Both of those applications were dismissed summarily by the Commission.[4]

On November 12, 1975, the Commission issued its opinion and order. It (1) found an overall 9.1% rate of return to be reasonable and necessary, (2) authorized an increase in Pepco's gross annual operating revenues of $27,657,000, and (3) determined the basic design of the new rates. Calculations pertaining to the revenue increase were based essentially upon a calendar 1974 test period. Commissioner Stratton vigorously dissented, citing the majority's refusal to allow properly for attrition as the principal reason for the Commission's failure to set rates at a level which would be sufficient to permit Pepco the opportunity to earn a reasonable rate of return. 11 P.U.R.4th at 237-51.

Pursuant to the Commission's opinion, Pepco filed a new schedule of rates on November 7, 1975. Thereafter, on December 3, 1975, Pepco petitioned the Commission for expedited review of those rates. The Commission approved the rate schedules on December 12, 1975, to become effective the following day.

Also on December 12, 1975, Pepco filed an Application for Reconsideration of Order No. 5739. That was denied in all relevant respects by the Commission in Order No. 5759 on January 12, 1976.

On appeal, Pepco accepts the 9.1% rate of return determined by the Commission, but charges that the Commission (1) arbitrarily refused to make use of the company's most recent actual operating data of record for the test period (*i.e.*, data for the 12-month period ended June 30, 1975) or, (2) in the alternative, failed to make adjustments to the calendar 1974 test period data for continuing attrition and for certain known changes of record which occurred during the first six months of 1975. Pepco alleges that it thus was denied a reasonable opportunity to earn the rate of return found necessary by the Commission to maintain the company's financial integrity. The Commission, on the other hand, defends its use of the 1974 test period and its limited allowance for attrition primarily by singling out two "reasons" for Pepco's rapidly declining financial condition during the test year —the energy crisis (which led to reduced consumption) and a decrease in sales of electricity to a pool of interconnected utilities—and by stressing their irrelevancy to forecasts of Pepco's financial needs. The proceeding now before us represents the fourth time in six years that Pepco found it necessary to apply to the Commission for rate increases.

[4] Pepco's first application for an interim rate increase was dismissed by Order No. 5707, issued on April 7, 1975; the second was dismissed by Order No. 5725, dated July 11, 1975. As Pepco has not challenged those orders on appeal, we do not consider their merits. They are, however, illustrative of Pepco's continuing efforts to seek rate relief from the Commission.

II. Scope of Review

In reviewing orders of the Commission in rate cases, our authority is delineated by D.C. Code 1973, § 43-706. It is limited to questions of law, and to findings of fact insofar as they may be "unreasonable, arbitrary, or capricious."[5] Congress properly has vested the Commission, not this court, with the primary ratemaking authority, although the Commission is bound both to exercise its powers rationally and lawfully, and to set rates that are

[5] *Chesapeake & Potomac Tel. Co. v. PSC*, D.C.App., 330 A.2d 236, 239 (1974); *Goodman v. PSC*, D.C.App., 309 A.2d 97, 100 (1973); *Tel. Users Ass'n v. PSC*, *supra* note 3, at 296.

"just and reasonable." D.C. Code 1973, §§ 43-301, -401, -411; *Chesapeake & Potomac Telephone Co. v. Public Service Commission*, D.C.App., 330 A.2d 236, 240 (1974). These standards are the same as those embodied in the Natural Gas Act, 15 U.S.C. § 717(c) and (d) (1970), and the Federal Power Act, 16 U.S.C. § 824(d) and (e) (1970). *See Washington Gas Light Co. v. Baker*, 88 U.S. App.D.C. 115, 118-19, 188 F.2d 11, 14-15 (1950), *cert. denied*, 340 U.S. 952, *appeal after remand*, 90 U.S.App. D.C. 98, 195 F.2d 29 (1951).

The constitutional basis for requiring utility rates to meet the test of reasonableness derives from the Fifth and Fourteenth Amendments. *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575, 582 (1942) (hereinafter *Natural Gas Pipeline*). The Supreme Court has held that rates which are not adequate to yield a reasonable return on the value of the property used by a utility company to furnish its service to the public are unjust, unreasonable, and confiscatory, and that their effectuation would deprive the utility of its property without due process or just compensation. *Natural Gas Pipeline, supra*, at 585-86; *McCardle v. Indianapolis Water Co.*, 272 U.S. 400, 408 (1926) (hereinafter *McCardle*); *Bluefield Water Works & Improvement Co. v. Public Service Commission*, 262 U.S. 679, 690 (1923) (hereinafter *Bluefield*).

Congress, however, has provided no formula for determining what constitutes rates which are "just and reasonable." To fill that void, the Supreme Court has expanded upon the statutory standard in the *Natural Gas Pipeline* case and its progeny. It is axiomatic that to be "just and reasonable," rates must be set at a level that permits the company to earn a fair rate of return on its investment. *See Federal Power Commission v. Hope*

Natural Gas Co., 320 U.S. 591, 603 (1944) (hereinafter *Hope*); *Natural Gas Pipeline, supra*, at 596-97; *McCardle, supra*, at 408-09; *Bluefield, supra*, at 690. While regulation does not guarantee that a utility will achieve its projected revenues, it must provide the utility with a reasonable opportunity to earn a rate of return sufficient to maintain the company's financial integrity, to attract necessary capital at a reasonable cost, and to compensate investors fairly for the risks they have assumed, while protecting the relevant public interests. *Hope, supra*, at 605. This involves a delicate balancing of investor and consumer interests. *Id.*, at 603.

No single formula—or combination of formulas—limits a regulatory commission's power to set "just and reasonable" rates. However, a commission is obliged to make pragmatic adjustments where appropriate circumstances exist. *Hope, supra*, at 602; *Natural Gas Pipeline, supra*, at 586. Courts may intervene only upon a "clear showing" of a due process violation. If the commission's order, viewed in its entirety, produces no arbitrary result, judicial inquiry is to be terminated. *Natural Gas Pipeline, supra*, at 586.

Thus, "it is the result reached not the method employed which is controlling." *Hope, supra*, at 602. Courts are to concern themselves primarily with the overall impact of a rate order, rather than with the theories behind it. *Ibid.* However, if the total effect of a rate order is found to be unjust or unreasonable, a reviewing court must delve into the details of the order. It must give reasoned consideration to each contested element of the rate order "to determine the possible presence of arbitrary action." [6]

[6] Arbitrary action is "action not based on facts or reason. The burden upon petitioner is . . . to demonstrate clearly and

Goodman v. Public Service Commission, D.C.App., 309 A.2d 97, 101 (1973) (hereinafter *Goodman*); *accord*, *Telephone Users Association v. Public Service Commission*, D.C.App., 304 A.2d 293, 298 (1973), *cert. denied*, 415 U.S. 933 (1974) (hereinafter *Telephone Users*). *See Permian Basin Area Rate Cases*, 390 U.S. 747, 790-92 (1968). Only in such a way may a reviewing court effectively evaluate the fairness and reasonableness, or the potentially confiscatory nature, of a particular rate order.

In the *Permian Basin Area Rate Cases*, *supra*, at 791-92, the Supreme Court summed up the responsibilities of a reviewing court:

> First, it must determine whether the Commission's order, viewed in light of the relevant facts and of the Commission's broad regulatory duties, abused or exceeded its authority. Second, the court must examine the manner in which the Commission has employed the methods of regulation which it has itself selected, and must decide whether each of the order's essential elements is supported by substantial evidence. Third, the court must determine whether the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable.

This court has adhered to the standards of review thus enunciated on several occasions.[7] In the instant case, we

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convincingly a fatal flaw in the action taken." *Goodman v. PSC*, *supra* note 5, at 101 (citations omitted).

[7] *See, e.g.*, cases cited in note 5, *supra*.

have examined the overall effect of the Commission's opinion, and find it to be unjust and unreasonable in that it deprived Pepco of the opportunity to earn a fair rate of return by improperly disregarding the latest relevant historical data of record pertaining to the company's operations. Examination of the elements of the opinion reveals several findings and conclusions (expressed in the Commission's opinion in an overlapping, narrative style) which are unreasonable, arbitrary, or capricious. These include the Commission's refusal to utilize the most recent test period in the record, its failure to account for continuing attrition, and its refusal to recognize certain known changes which occurred after the originally proposed calendar 1974 test period.

III. The Overall Effect of the Commission's Opinion and the Rate of Return

Basic to Pepco's arguments is the contention that the Commission effected an unreasonable and arbitrary result when it established a rate base—and thereby provided for revenues—that deprived the company of any opportunity to earn the rate of return which was found reasonable and necessary by the Commission itself.[8] In its opinion, the Commission initially found "that a fair

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[8] For utility ratemaking purposes, the rate base multiplied by the rate of return (with the necessary adjustments for the company's income tax liabilities) determines the revenue requirements. "Rate base" has been defined as the value of a company's property used and useful in the public service minus accrued depreciation. *See Telephone Users*, *supra*, at 297 n.6. For discussions of rate of return, see *Williams v. WMATC*, 134 U.S.App.D.C. 342, 348, 415 F.2d 922, 928 (1968) (en banc), *cert. denied*, 393 U.S. 1081 (1969), and *D.C. Transit System, Inc. v. WMATC*, 121 U.S.App.D.C. 375, 400-01, 350 F.2d 753, 798-99 (1965) (en banc), *cert. denied*, 389 U.S. 847 (1967).

[overall] rate of return for Pepco is 9.1%." It further concluded that:

> In order to attract equity capital, a return on equity of 13% is required by PEPCO; and we find an equity return at that level to be fair and reasonable.

Notwithstanding those conclusions, by arbitrarily disregarding actual, historical, and uncontroverted data submitted as evidence by Pepco during the extended course of the hearing, the Commission all but guaranteed that the company would not be able to approach earning the rate of return it authorized.

The process of ratemaking involves the making of an honest and intelligent forecast of probable future values based upon all relevant circumstances, including primarily known performance during a period of time in the immediate past (*i.e.*, a test period). *See West Ohio Gas Co. v. Public Utilities Commission (No. 2)*, 294 U.S. 79, 82 (1935) (hereinafter *West Ohio Gas*); *McCardle, supra*, at 408-09; *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U.S. 276, 288 (1923); *Id.*, at 291-92 (Brandeis, J., concurring in the judgment); *Telephone Users, supra*, at 297. The validity of the test period approach rests upon the assumption that the relationship among revenues, expenses, and rate base which were established in the test year will continue into the near future, when the prescribed rates will be in effect.[9] *See Letourneau v. Citizens Utilities Co.*, 128 Vt. 129, 259 A.2d 21, 24 (1969).

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[9] Emphasizing the predictive value of test year "relationships," Commissioner Stratton stated in his dissent:

> The purpose of [the test period approach] . . . is *not* that future rates are reasonable if in the test year they would have produced a fair return, or that the increase in revenues that would have produced a fair return in the test year is ipso facto the increase that will do so in the future. The test year approach assumes—and this is vital to an understanding of it—that the *relationship* among revenues, expenses, and rate base that obtained in the test year will continue into the future. Only if this assumption is valid does it follow that rates which would have produced a fair rate of return in the test year will produce a fair rate of return in the future.

Accordingly, a valid test period must be based upon the utility's most recent actual experience, with adjustments for all known changes affecting costs and revenues for the immediate future. *Telephone Users, supra*, at 297; *Southern New England Telephone Co. v. Public Utilities Commission*, 29 Conn. Supp. 253, 282 A.2d 915, 919 (Super. 1971); *Letourneau v. Citizens Utilities Co., supra*, 259 A.2d at 23-24; *see Boston Gas Co. v. Department of Public Utilities*, 359 Mass. 292, 269 N.E.2d 248, 259 (1971); *New York Telephone Co. v. Public Service Commission*, 29 N.Y. 2d 164, 272 N.E.2d 554, 324 N.Y.S.2d 53 (1971). *See also Goodman, supra*, 309 A.2d at 100. It is well settled that the rate maker may not rely on out-of-date information when more recent actual experience, which shows a substantial disparity between the earlier forecasts and the rate of return actually earned, is available. *West Ohio Gas, supra*, at 82. Suitable adjustments must be made to accommodate the latest available relevant data which are received in evidence.

> To shut one's eyes to [the latest available figures] altogether, to exclude them from the reckoning, is as much arbitrary action as to build a schedule upon guesswork with evidence available. [*Id.*, at 81-82.]

See New York Telephone Co. v. Public Service Commission, supra (PSC reversed for refusal to reopen hearing to receive actual data which differed from projections).

A. *The Most Recent Available Data*

Pepco submitted to the Commission clear and uncontroverted evidence of its rapidly declining financial position on several occasions during the 11½ month period between the filing of the original application and the issuance of the Commission's opinion. In its application, Pepco first based its rate request, upon a calendar 1974 test period, but it also forecast its operating results for 12-month test periods ending March 31, 1975, June 30, 1975, and December 31, 1975.[10] When filed, those projected figures were not nearly as high as those later found to be required by the Commission, and actual experience proved them to be unduly optimistic. *See West Ohio Gas, supra*, at 82. The forecasts, as well as the actual, historical data submitted by Pepco, reflected continuing attrition; that is, a chronic inability on the part of the company to earn its authorized rate of return

[10] The forecasts reflected the following data:

	12 Months Ending		
	March	June	December, 1975
Return on Rate Base (unadjusted)			
End of Period	7.09%	7.08%	7.07%
Average	7.63%	7.52%	7.29%
Return on Equity			
End of Period	9.3 %	9.0 %	7.6 %
Average	9.7 %	9.1 %	8.1 %

because the increases in its expenses and/or rate base consistently outpaced its increases in revenues.[11]

The Commission further was alerted to the dramatic effects of continuing attrition on the utility when Pepco filed two requests for interim rate relief, subject to refund, pending the Commission's final opinion. The company filed the interim requests with a realization that its financial position was declining rapidly during the interval which was occasioned by administrative delay. As noted, the interim applications were filed in March and July of 1975, respectively, and were accompanied by updated direct testimony and exhibits reflecting a continuing deterioration in operating results. As we have noted, the Commission denied those applications.

Cross-examination with respect to Pepco's direct presentation began on June 4, 1975. The company's witnesses pointed out the severe attrition which had been experienced by Pepco since the end of 1974, and demonstrated that the test period originally proposed had become irrelevant to the company's actual financial status.[12]

[11] *See Telephone Users, supra*, at 298. In his dissent, while distinguishing between rate base and expense attrition, Commissioner Stratton emphasized his disagreement with the majority's treatment of manifest rate base attrition as minimal or nonexistent:

> Where I part company with the Commission is in its treatment of the attrition malady for which the remedy prescribed lies somewhere between a placebo and bloodletting.

[12] A company official emphasized that sharply escalating plant and financing costs, dramatic increases in fuel costs resulting from the national energy crisis, substantial construction programs only recently curtailed, and rapidly rising and embedded costs of senior capital were responsible for the

The principal Commission Staff witness, while adhering to the calendar 1974 test period, also recognized and deplored the continuing presence of attrition.[13]

Pepco then prepared a compilation of actual operating results for the 12 months ended June 30, 1975. That submission was filed on July 18, 1975, with the company's prepared rebuttal testimony. That filing was made during the cross-examination of the witnesses for the Commission's Staff and the intervenors. The cross-examination of Pepco's rebuttal witnesses began on July 23, 1975.[14]

Pepco's presentation of the updated test period data was in the same format as had been utilized in its original application (filed on December 20, 1974), and as it thereafter had been amended to show actual 1974 results. Only the numbers were changed to reflect the significant intervening alteration in Pepco's financial status due to continuing attrition.

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company's deteriorating financial situation. The official's testimony was supported by several independent analysts, as well as by other company representatives.

[13] The Staff witness stated: "In [the prior 1973 rate order] the Commission found 'a classic picture of attrition' and used an end-of-period rate base for rate making purposes. * * * [T]he Staff is of the opinion that the conditions existing in [the 1973 rate case] that led to the finding of attrition are still present."

[14] The chronology of the hearing was as follows. The cross-examination of Pepco's direct case began on June 10 and ended on June 23, 1975. The cross-examination of the Staff and intervenors' witnesses lasted from July 2 to July 23, 1975. The cross-examination of Pepco's rebuttal witnesses began immediately thereafter, and terminated on July 24, 1975.

As part of this presentation, Pepco introduced into the record the following table of actual results of the company's operations:

	Earnings Per Share of Common Stock	Ratio of Earnings to Fixed Charges	Return on Average Common Stock Equity Capital
Year			
1968	$1.35	2.94x	10.5%
1969	1.09	2.28	8.3
1970	1.25	2.10	9.1
1971	1.33	2.10	9.4
1972	1.53	2.58	10.5
1973	1.71	2.70	11.4
Twelve Months Ended			
June 30, 1974	1.87	2.81	12.3
July 31, 1974	1.86	2.74	12.2
August 31, 1974	1.78	2.63	11.7
September 30, 1974	1.76	2.56	11.5
October 31, 1974	1.72	2.51	11.3
November 30, 1974	1.70	2.47	11.1
December 31, 1974	1.63	2.43	10.7
January 31, 1975	1.57	2.36	10.3
February 28, 1975	1.52	2.30	9.9
March 31, 1975	1.44	2.20	9.5
April 30, 1975	1.32	2.09	8.7
May 31, 1975	1.24	2.01	8.2
June 30, 1975	1.21	1.90	8.1

Pepco's witness stressed that the practical effect of those results was to preclude the company from "obtain[ing] additional capital funds in the public securities markets on any acceptable terms." [15] Characterizing Pepco's position as "critical," he continued:

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[15] The official further testified that any attempt to obtain financing through common stock or debt offerings either

> Pepco has clearly begun to lose [investor] confidence and the loss will accelerate unless the Company is able to obtain the rate relief sufficient to achieve the level of results required to enable the Company to retain present and attract potential investors in its securities.[16]

No substantial objection to the content of Pepco's rebuttal testimony was made, and no issue was raised con-

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would be illegal (if the market price fell below par value, which then seemed likely), or at the very least,

> would compound the present process of deterioration in Pepco's financial situation to a point that recovery of satisfactory financial health would require more time and more rate increases.

Moreover, he stated:

> Pepco's position is critical. For all practical purposes Pepco is foreclosed from the public capital markets at a time when the Company has $60 million of outstanding short-term debt. The continuation of our minimum construction program will necessitate increasing the Company's short-term debt to approximately $100 million by the end of the year, with further increases during 1976. It is imperative that the Company be placed in the position of being able to finance these expenditures with permanent capital. However, until Pepco is able to again demonstrate at least minimum levels of earnings on its common stock and adequate margins of protection for investors in senior securities, its access to the organized capital markets will continue to be blocked.

[16] The Pepco witness added that once lost, investor confidence could be reestablished only with substantially higher earnings than are required simply to maintain such confidence. In addition, the recovery process would be particularly slow and painful for the company since it is still remembered by many investors as "the only significant electric utility, other than Consolidated Edison, to have omitted a cash dividend on its common stock in modern times."

cerning the calculation of the rate base utilizing the actual data for a test year ended June 30, 1975.

Subsequent to the hearing, Pepco supplied for the record its financial results for the 12-month periods ended July, August, and September of 1975 as they became available:

	Earnings Per Share of Common Stock	Ratio of Earnings to Fixed Charges	Return on Average Common Stock Equity Capital
Twelve Months Ended			
July 31, 1975	$1.21	1.90x	8.1 %
August 31, 1975	1.18	1.90	7.9
September 30, 1975	1.16	1.89	7.78

Finally, in its brief, oral argument, and petition for reconsideration before the Commission, the company repeated its need for greater rate relief than that afforded by rates based upon the outdated calendar 1974 test period.

B. *The Commission's Exclusion of the Most Recent Available Data*

Pepco's pleas, however, went largely unheeded. Despite a pro forma recitation to the contrary, the Commission's opinion effectively ignored the overall impact of continuing, post-1974 attrition on the company's financial integrity.[17] Concurring generally with the recom-

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[17] The Commission took "official notice" of certain 1975 operating data, principally to project an offset of retail sales against PJM interchange sales. *See* note 19, *infra*. Additionally, the Commission made two minor rate base adjustments to reflect 1975 data, namely a union wage increase and

mendations made by its Staff, the Commission de-emphasized the role of attrition in Pepco's financial woes, selecting instead two phenomena allegedly unrelated to attrition—the 1974 energy crisis and a decrease in sales to a pool of interconnected electric companies—as the primary "causes" of Pepco's economic troubles. In so doing, the Commission did acknowledge the historic problem of attrition and expressed concern over its own ineffectiveness in coping with the company's financial problems in the past. Nonetheless, it did not even mention the substantial data reflecting 1975 financial developments which were submitted by Pepco on numerous occasions. Such data, manifestly relevant and significantly different from the outdated statistics relied upon by the Commission, were presented by Pepco in the following ways: (1) in the forecasts and trends filed with the original application; (2) in the two later requests for interim relief, which were supported by updated testimony and exhibits; (3) during the cross-examination of the company's witnesses in its direct and rebuttal cases; (4) in the testimony of the Commission's own Staff witnesses; (5) in the presentation prior to the closing of the record of actual figures for the more recent test year ended June 30, 1975; and (6) in written and oral submissions made after the closing of the public hearing. The Commission's exclusion of this substantial and relevant evidence from its consideration was an unreasonable and arbitrary exercise of its ratemaking authority.

The overall effect of the Commission's opinion was to deny Pepco the chance to earn the rate of return termed

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a gross receipts tax increase, and took into consideration 1975 stock sales and a 1975 debt retirement. Otherwise, the Commission based its entire discussion on data derived during the years 1970-74.

"required," "fair," and "reasonable" in the opinion itself. Actual, historical evidence which was in the record for at least several months prior to the issuance of the Commission's opinion clearly demonstrated that Pepco's rate of return on equity had declined steadily—from 10.7% on December 13, 1974, and to 8.1% on June 30, 1975 (and, after the record was closed, to 7.78% on September 30, 1975). The order under review, supposedly designed to raise Pepco's return on common equity to 13% from the 10.7% actually experienced as of the end of 1974, could not conceivably raise Pepco's return on equity to the "required" 13% level from the 8.1% rate experienced by the company as of June 1975 (or from the 7.78% rate experienced as of September 1975).

The one significant attrition-related rate base adjustment made by the Commission, that of using year-end 1974 data for Plant in Service, reflected only a general consideration of the historical trend of such costs. The available post-1974 data of record were excluded from the calculations.

In its brief before us, the Commission characterizes Pepco's complaint as one directed essentially toward "the ever present problem of regulatory lag—an unfortunate —but inevitable part of the regulatory process," the risk of which must be shouldered by the company and its investors.[18] However, the readily recognized problem of regulatory lag has been considered by the Commission in earlier cases as a factor to be dealt with in calculating

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[18] In her oral argument, People's Counsel likewise stated:

> Those investors who invest in the common stock of a regulated industry are given an opportunity to earn a fair, reasonable rate of return. [But] this is not [fool-] proof. This is something which does have risks attached to it. * * * One of these risks is, of course, regulatory lag.

the rate of return, and as one to be allocated equitably to consumers as well as investors. *Chesapeake & Potomac Telephone Co. v. Public Service Commission, supra,* at 241-42 (permitting an interim adjustment for future lag); *Telephone Users, supra,* at 299 n.15 (justifying the use of a year-end rate base in light of evidence of regulatory lag and attrition). Realistic ratemaking in today's economic climate must take into account the lengthening delays occasioned by the regulatory processes, while recognizing the need for preserving an appropriate balance between investor and consumer interests. In the instant case, the Commission arbitrarily and unreasonably cited the problem of regulatory lag in an effort to justify its failure to strike the needed balance by utilizing the company's most recent historical data of record.

Urging the use of the most current actual data available, the Supreme Court has warned that "elaborate calculations which are at war with realities are of no avail." *Lindheimer v. Illinois Bell Telephone Co.*, 292 U.S. 151, 164 (1934), quoted in *West Ohio Gas, supra,* at 82. The Commission in this case, electing not to be attuned to the realities of continuing inflation and attrition, refused to take proper cognizance of known and relevant changes of record. It thereby disadvantaged both investor and consumer interests, and denied Pepco its constitutionally-guaranteed opportunity to earn a fair rate of return on its investment. The exclusion of the most recent available data from consideration and evaluation by the Commission was arbitrary in nature, confiscatory in effect, and made its decision one which is inconsistent with both reason and the evidence. *See Telephone Users, supra,* at 300-01. *See generally West Ohio Gas, supra,* at 82; *New York Telephone Co. v. Public Service Commission, supra.*

IV. The Elements of the Commission's Order: The Correct Test Period

Having concluded that the overall effect of Order No. 5739 was unjust and unreasonable (D.C. Code 1973, §§ 43-301, -401, -411), we must proceed to consider the elements thereof challenged by Pepco. *See Telephone Users, supra,* at 298; *see also Permian Basin Area Rate Cases, supra,* at 790-91. Primarily, the company contends that the Commission erred in refusing to replace the outdated calendar 1974 test period data with the actual data submitted for the 12-month period ended June 30, 1975. According to Pepco, the striking increases in its expenses and the precipitous decline in its earnings, clear evidence of which was duly made a part of the record, unequivocally showed the 1974 test year to be unrepresentative of the future period during which the new rates would be in effect. The company emphasized that its revenue/expense/rate base relationships had changed so significantly that application of the Commission's own ratemaking formula to the more recent data would have necessitated an increase of $48.6 million in revenues, rather than the $27.7 million actually authorized. When accompanied by the actual figures reflecting Pepco's continuing decline in its rate of return on equity, the evidence demonstrated clearly and convincingly that only rates based upon the latest available data of record—data for the 12 months ended June 30, 1975—could have afforded the company an opportunity to approach earning the rate of return found to be required by the Commission to maintain the utility's overall financial integrity, to retain investor confidence, and to assure the economic viability which is vital to Pepco's continued ability to provide reliable service to the public.

In seeking to justify its use of the calendar 1974 test period, the Commission concluded that there were two

primary "causes" of Pepco's financial decline during the latter part of 1974 which rendered the test year both historically "atypical" and presently representative of a "new normalcy." A substantial decrease in retail sales due to energy conservation during the fuel crisis which surfaced in 1974 and a significant drop in energy sales to a pool of utility companies were cited as the two factors which distinguished 1974 from earlier years.[19] They allegedly were responsible for the downward trend in earnings, a trend which the Commission acknowledged "shows no sign of reversal." The calendar 1974 test year therefore was selected over previous years as being "more representative of conditions reasonably expected to exist in the future." It also was chosen, however, without reference to known changes of record occurring more recently than the end of 1974, as we have discussed.

The Commission further found (although its dissenting member disagreed) that these "causes" were not related to attrition. The Commission's majority stated, however, that

> the record is clear that the increase in investment costs per unit of output noted in our last decision has continued, * * * [so] we are persuaded that attrition is a phenomenon that is still with us, and we will therefore now, as we have in the past, use an end of period rate base, with appropriate adjustments, in order to compensate for the presence of attrition.

[19] Pepco is one of approximately 12 utilities which comprise the Pennsylvania-New Jersey-Maryland (PJM) Interconnection. As a PJM member, Pepco has used the interconnected transmission systems to relieve its customers of a significant part of the carrying costs of its facilities by means of off-peak kilowatt-hour deliveries to PJM from Pepco's plant which would otherwise be idle during periods of low demand. The company also purchases energy from other PJM utilities when it is economically or technically beneficial for it to do so. Pepco's participation in PJM has served to reduce its overall cost of service, thereby considerably benefitting its retail customers. However, circumstances have combined to reduce Pepco's PJM sales significantly.

The reasoning and conclusions thus enunciated are incongruous. The Commission found the 1974 earnings trend to be decreasing at a faster pace than that experienced in previous years, and admitted that "the time, effort and expense involved in the 1970, 1972, and 1973 PEPCO cases appear to have been ineffectual in solving the economic problems of this utility." [20] This acknowledgement was made in the face of record evidence demonstrating that Pepco failed by significant margins to earn the rates of return found necessary by the Commission in 1970 and 1973, or at any time from 1970 to 1975. The company's rate base increased almost three times as fast as its operating income from 1973 to 1975. Notwithstanding such facts and findings, the Commission proceeded nominally to apply the same remedy used in the earlier rate cases—an end-of-period rate base. However, it then diluted that remedy by including the lower average figures for Construction Work in Progress (CWIP) and Materials and Supplies (M&S). Those adjustments alone arbitrarily reduced the company's rate base by a total of approximately $36.8 million, and correspondingly reduced its revenue requirements by approximately $7.5 million.

By adopting a diluted, end-of-1974 rate base, the Commission all but made it certain that Pepco would not be

[20] *See Re Potomac Electric Power Co.*, 3 P.U.R.4th 65 (PSC D.C. 1973); *Re Potomac Electric Power Co.*, 95 P.U.R.3d 99 (PSC D.C. 1972); *Re Potomac Electric Power Co.*, 83 P.U.R. 3d 113 (PSC D.C. 1970).

able to earn the rate of return which the Commission found to be necessary to attract capital and maintain investor confidence. In an attempt to keep rates down, the Commission impermissibly ignored the consumers' and the investors' long-range concerns with the financial stability of the utility.[21] *See Hope, supra,* at 603; *Bluefield, supra,* at 692-93, *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission, supra,* at 291-92 (Brandeis, J., concurring in the judgment).

Reviewing the abundant record evidence of Pepco's precipitous decline in earnings beginning mid-way through 1974 and continuing unabated into 1975, we conclude that the Commission's decision to use a partially end-of-period calendar 1974 rate base was arbitrary as a matter of law. The revenue/expense/rate base relationships that allegedly would have provided a fair rate of return during calendar 1974 manifestly had changed, and no longer could be relied upon to produce a fair rate of return during the future period when the new rates would be in effect. The requisite "delicate balance" between investor and consumer interests was not attained, as the burden of shouldering the losses was placed only upon the company and its investors.

Confronted with strikingly similar circumstances in a telephone company rate case, the New York Public Service Commission routinely incorporated data from the six months following the originally-filed test period into a new test year. *City of New York v. Public Service Commission,* 42 App.Div.2d 259, 346 N.Y.S.2d 6 (1973). That commission explained its adoption of the substituted test year "by stating that it would be unfair to the Company

[21] The Commission's principal Staff witness had acknowledged that the remedy ultimately prescribed would be insufficient to alleviate Pepco's financial woes.

not to include actual operating results for the first six months of 1971." 346 N.Y.S.2d at 8. In the instant case, the Commission should have reached the same conclusion.[22]

Furthermore, by focusing narrowly on two isolated "causes" of the company's financial decline and distinguishing them from attrition-related factors (for which year-end or other adjustments are made), the Commission failed properly to evaluate and deal with Pepco's overall economic problems. We agree with dissenting Commissioner Stratton's assessment of the majority's action:

> With today's decision the commission takes a giant step—backwards. Backwards into the rate-making ethos of a departed era when the harsh realities of an uncertain energy environment, and rampant inflation were not with us. Today's

[22] The necessity to insure that the rates set would be fair and would have meaningful predictive value led one commission to utilize a *future* test period accompanied by a fully projected rate base. *Re Georgia Power Co.,* 9 P.U.R.4th 381 (1975). Finding that this would eliminate attrition for the test period, the Georgia commission concluded that any difference between the allowed and actually experienced rate of return would be accounted for instead by errors of projection. According to that commission, such errors would prove less detrimental to the public interest than the unknown effects of future attrition. *Id.,* at 385-86.

Another commission solved the problems of attrition and regulatory lag by utilizing a rolled-in test year (*i.e.,* one which "proformed" [*sic*] the capital structure to encompass the upcoming calendar year). *Re Central Maine Power Co.,* 8 P.U.R.4th 277 (1975). That solution simultaneously avoided the prophesies inherent in future test years, and the inevitable imbalance of year-end rate bases. *Id.,* at 286. Thus, the Commission's error in the instant case is seen to be egregious in view of the many alternative means available to it for setting realistic and non-confiscatory rates.

> decision denied the reality, abundantly demonstrated in the record, of remorseless price escalation in virtually every component of the cost of service, and by doing so insures the prompt relitigation of all the issues in this case.

The Commission further attempts to justify its failure to utilize a test period ended June 30, 1975, by attacking the procedural aspects of Pepco's introduction of the new data into evidence. The Commission first argues that Pepco did not manifest an intention to have the data for the 12-month period ended June 30, 1975, constitute the bases for a more valid test period. To support this contention, the Commission excerpted from the testimony of a Pepco official the following:

> . . . we are not—not suggesting a substitution of the June 30 year for the December 31 year, but I do ask . . . that the Commission take note of this information and apply it in reaching the conclusions in this case.

By the date of that isolated bit of testimony, seven months already had elapsed since Pepco filed its rate increase application. During that time, the company's financial situation rapidly was worsening and its earnings level was approaching the annual dividend level.[23] Two urgent requests for interim rate relief subject to refund had been denied. The company was experiencing an actual

[23] During oral argument before us, Pepco's counsel contended that after filing its initial rate request, the company "fell immediately into a financial decline" described as "the worst in Pepco's history," worse, in fact than that of 1969, "when the company was forced to halve its accrued dividends." This same point had been made during the administrative hearing, by Pepco's President and Chairman of the Board, in direct testimony during the rebuttal phase.

loss of $75,000 per day during the delay, and understandably was seeking expeditious resolution of its rate increase application. Confronted with those realities, the Pepco official urged the substitution of the most current information available (that for the year ended June 30, 1975), but did object to any reopening or continuance of the hearings to consider the new data. He stated:

> A. There should be ample opportunity between now in July and the time the case is concluded for the Commission staff to review the June figures and assure themselves that it [*sic*] is comparable to the December figures that were originally submitted.
>
> Q. But we are still operating on the basis of a 1974 test year for the purposes of this proceeding; correct?
>
> A. Yes. I think it would be far preferable to use the most current information that is available, which would be June, but we would not want to introduce a delay by doing so, and we thought this would be, to present it now as a complete summary of the June figures and also to present the June figures in the same form as they were submitted by the staff would make it as convenient as possible for the Commission to use those figures in reviewing the case.

In this context it is apparent that the Pepco official intended that the most recent data be utilized in lieu of the outdated 1974 figures, but was reluctant to insist upon the substitution *if* doing so would risk further substantial delay. Moreover, on the next day, the President and Chairman of the Board of Pepco unequivocally urged

the adoption of the most recent data within the test period. He testified:

> I will be quite candid and open with this Commission and everybody in the room. I instructed you, Mr. Hobelman, and lawyers in this case to update the test year, and for the June 30 test year, in this case. * * * I say to this Commission that I would urge the Commission to base its results on the June 30 figures. There is plenty of time for staff audit of those figures. All of the issues have been examined by the intervenors, by People's Counsel. There is nothing which should require, in my opinion, a delay about it.

In addition, Pepco's intent to have the Commission follow the accepted regulatory practice of basing its rate determinations upon the utility's most recent actual data was manifested by its presentation of the new data on the basis of the same formulas, and in the same format, as the 1974 data originally filed. Only the numbers were changed to reflect Pepco's worsening economic situation. Those changed numbers represented the most recent historical data which the Commission was bound to take into account. *See West Ohio Gas, supra,* at 82; *Telephone Users, supra,* at 297; *New York Telephone Co. v. Public Service Commission, supra.* They were not forecasts, which traditionally have been accorded special treatment in ratemaking proceedings.[24] In both the testimony and

[24] Forecasts play two important roles in the ratemaking process. "There are times, to be sure, when resort to prophecy becomes inevitable in default of methods more precise." *West Ohio Gas, supra,* at 82. *See Southwestern Bell Tel. Co. v. PSC, supra,* at 288. In addition, forecasts supplementing actual experience are essential to a determination of prospective rates. This court recently has held that the Commission's refusal to consider forecast data in a ratemaking proceeding

the actual historical data, therefore, there was sufficient evidence of the company's intent on the record to warrant our concluding that a finding to the contrary was arbitrary and capricious.

The Commission also argues that the new data were filed too late, and that its adoption of the new test period would have unduly prolonged the proceeding and prejudiced the rights of other parties. However, in reciting only: (1) the fact that the new data were filed with the rebuttal testimony; (2) the truism that "[a]ny proceeding simply must come to a conclusion at some point"; and (3) that the adoption of the new operating results would "necessitate further proceedings in recognition of the procedural rights of the other parties," the Commission failed to substantiate its conclusion regarding any possible delay and potential prejudice which might have resulted from its utilization of the new test period data.

The new data were filed in ample time to allow for Staff and intervenor analysis and cross-examination, and no party sought additional time to review the updated facts. No objection was made to the admission of the testimony and its accompanying exhibits. No new issue concerning the revenue/expense/rate base relationships was raised either during cross-examination of the company's rebuttal witness (which began five days after the new data were filed), or during the five months after the hearings, during which time briefs were filed, oral arguments were heard, and the two orders appealed from were issued.[25] Finally, Pepco offered to await audit of

was reversible error. *Telephone Users, supra,* at 300-01. Nonetheless, "prophecy, however honest, is generally a poor substitute for experience." *West Ohio Gas, supra,* at 82.

[25] In its brief on appeal, People's Counsel suggests that the adoption of the updated test year ended June 30, 1975, may

the new data, and certainly there was more than ample time during the nearly four months which elapsed between the hearings and the Commission's decision for such an audit to be accomplished.[26] It was only after the Commission issued its opinion, and Pepco filed its Application for Reconsideration, that arguments were advanced against utilizing the most recent actual data.

As the new data thus consisted only of historical figures which were uncontested, timely filed, and easily audited, considerations of due process would not have required an extension or reopening of the hearings to admit further testimony concerning the new data. *See, e.g., Re Delmarva Power & Light Co.*, 337 A.2d 517,

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have required a revenue and expense adjustment to "synchronize" those elements with the company's investment in its new plant, Chalk Point Unit No. 3. However, People's Counsel does not cite, and we cannot find, evidence to support this contention so belatedly raised. Moreover, the principal Staff witness, when cross-examined on the subject, stressed that any such attempt at synchronization would be ". . . too speculative for my purposes," and would have deprived Pepco of the benefit of even the partially year-end rate base which he proposed, and then conceded was inadequate to counteract the effects of existing attrition.

[26] As noted, Pepco facilitated audit of its most recent data by submitting them in accordance with the Staff's formulas and format, as it did in its original submission. Moreover, as is generally known (and was confirmed at oral argument), members of the Staff continuously audit the company's books, which are maintained in accordance with a Commission-prescribed uniform accounting system. Verification of the latest actual data therefore would have required minimal additional time and effort on behalf of the Commission's Staff and the intervenors. Additionally, in its opinion the Commission specifically acknowledged: "On this record, few if any questions were raised about the income, expense, and operating results recorded on the PEPCO's books."

518-19 (Del. Super. 1975); *City of New York v. Public Service Commission, supra*, at 9. This should have been apparent to the Commission, as reflected by our reasoning in *Telephone Users, supra.* In that case, the utility sought to introduce two additional wage adjustments as part of its rebuttal case, despite the fact that the company was fully aware of the pending changes at the time of its direct testimony. The Commission disallowed the adjustments, concluding that they did not afford the Staff or intervenor the opportunity to present evidence of offsetting adjustments without unduly prolonging the proceeding. We reversed, citing the following four factors as the bases for our holding: (1) the fact of the wage increase was known to all parties before the hearings began (it arose from a three-year contract between the utility and the union); (2) only the amount of the wage increase initially was unknown; (3) the company's counsel alerted all parties at a prehearing conference that the company might seek allowance for the added employee expenses; and (4) the additional expenses were submitted in the utility's forecast of operations filed two weeks before the Staff filed its evidence. 304 A.2d at 302.

Similarly, in the instant case: (1) the fact of Pepco's rapidly deteriorating financial condition and corresponding need for greater rate relief than that which would be afforded by employing the 1974 data was made known to all parties long before the hearings began (in the forecasts filed with the original application and in the interim rate requests accompanied by fully updated testimony and exhibits); (2) only the exact amounts of Pepco's later rate base components and financial requirements were unknown until the more current data were filed; (3) all the parties were alerted to the need for updating the test period both when the interim rate increase applications were filed and during Pepco's direct

testimony; and (4) data for the successive 12-month periods ending January through May of 1975 were submitted in support of Pepco's request for interim rate increases, and hence were available for some time prior to the filing of the Staff's and intervenors' evidence.

The Commission contends that unlike the wage adjustment in the *Telephone Users* case, Pepco's new test period figures were not "known and certain" changes of record. We disagree. The new data reflected only actual, historical evidence of the company's financial situation for the 12-month period ended June 30, 1975. They included no estimates, conjecture, or forecasts.[27] Their authenticity was not challenged during or after the hearings. The new data consisted only of known changes of record, and the Commission erred in failing to use the figures for the 12-month period ended June 30, 1975—the most recent actual data available—to establish the test period upon which to base its calculations of Pepco's allowable retail rates. *Cf. Boston Gas Co. v. Department of Public Utilities, supra; New York Telephone Co. v. Public Service Commission, supra.*

V. The Existence and Effect of Attrition

So holding, we address Pepco's additional challenges to Order No. 5739, primarily to aid the Commission both on remand and in future rate proceedings. Our conclusions hopefully will reduce the necessity for Pepco so frequently to initiate new rate proceedings, the substantial costs of which inevitably are borne by the consumers.

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[27] The inclusion of forecasts, however, would not necessarily excuse the Commission for its failure to adopt the new test period. *See* note 24, *supra.*

Pepco contests the Commission's rejection of attrition as the major reason for the company's continuing financial decline. Attrition is the phenomenon which occurs when the utility's investment in rate base, or the operating expenses required to produce a unit of sales, or both, rise at a faster rate than the revenues from such sales. *Telephone Users, supra,* at 298; *Boston Gas Co. v. Department of Public Utilities, supra,* 269 N.E.2d at at 257 n.19. The largest single component of a utility's overall rate base is the value attributed to its Plant in Service. Typically, particularly for an electric utility, the next largest component is Construction Work in Progress (CWIP), which covers expansion projects prior to their completion, at which time their value simply is transferred to the Plant in Service account. In previous rate cases, the Commission recognized the serious attrition problem facing Pepco, and sought to help compensate for it by adopting year-end, rather than weighted average, figures for all such rate base components. *See Re Potomac Electric Power Co.,* 3 P.U.R.4th 65 (PSC D.C. 1973); *Re Potomac Electric Power Co.,* 83 P.U.R. 3d 113 (PSC D.C. 1970). In the instant case, the Commission again recognized the continuing adverse impact of attrition on the company's earnings, and acknowledged that the previously-applied remedy of a fully year-end rate base had not been effective.[28] Nonetheless, it pro-

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[28] At the outset of its decision, the Commission observed:

> [T]his decision will be the fourth decision by the Commission in the past six years on rate increase applications by PEPCO. We make this observation not by way of criticism of either PEPCO or our regulatory predecessors, but rather as an expression of our deep concern that the time, effort and expense involved in the 1970, 1972, and 1973 PEPCO cases appear to have been ineffectual in solving the economic problems of this utility.

ceeded to make a smaller allowance for attrition than it had in the past. This was done (1) by using year-end figures only for the Plant in Service component of the rate base, (2) by applying the lesser average figures for CWIP and Materials and Supplies (M&S), and (3) by locking into the new rates based on those components an unreasonably high allowance for net profits which the Commission purported to believe would result from the sale of excess generating capacity to the PJM Interchange pool.

Pepco's protestations concerning the Commission's unwillingness to combat attrition permeate the record, and form the bases for the company's specific allegations of error. Arguing an alternative, however undesirable, to the formal adoption of the updated test period for the year ended June 30, 1975, Pepco contends that year-end, rather than weighted average, figures for CWIP and M&S should have been included in its rate base. As noted, Pepco also argues that the test period should have been adjusted to reflect several major known changes of record.

Deferring, for the moment, consideration of those specific allegations of error, we note generally that the historical evidence of Pepco's precipitous decline in rate of return and earnings (which began in mid-1974 and continued unabated through 1975) was thoroughly documented in the record, as discussed above. However, by disregarding the evidence submitted in 1975, and by rationalizing that the 1974 decline was attributed to factors allegedly unrelated to attrition (*i.e.*, the energy crisis and a decline in sales to the PJM Interchange pool), the Commission arbitrarily utilized a test period and a consequent rate base devoid of predictive value.

In his dissent, Commissioner Stratton criticized the majority for its failure to adopt a reasonable approach to correct or compensate for expense as well as rate base attrition:

> By following the traditional test-year ratemaking approach in this case without making an appropriate allowance for attrition, the commission assumes that the distorted revenue/expense/rate base relationship in which this order is rooted will apply in 1976 and beyond, so long as this order is in effect. At the same time, protestations of bewilderment are entered at the fact that this is the company's fourth rate case in six years. The reason is obvious: increases in expense and rate base outpaced the increases in revenue after the 1970, 1972 and 1973 rate cases, as they will do after the 1975 case in the absence of an order that recognizes the fact and allows for it. Unhappily, the commission has done no more in this case than to set the stage for lamentations over the company's fifth rate request, which is sure to come in the near future. For, if ever a record demonstrated attrition, this one does. If ever a record called for realistic steps to deal with attrition, this one does. If there was ever a demonstration of the failure of revenue growth to keep up with the growth of expenses and investment, it appears in the record spread before the commission in this case, where there are data not only for the test year but also for the nine months following—data which the commission accepted into the record, I had thought, for the purpose of reaching a decision that took account of the real world as it was revealed to us by the operating

> results of the company during the pendency of the case.

We agree with his evaluation.[29]

When the Commission concluded that "attrition in the future may play a less significant role than it has in the past," it ignored the substantial, uncontradicted evidence of record demonstrating an unabated and exacerbated decline in both the company's earnings and actual rate of return. It premised its conclusion on the following three findings, all disputed by Pepco: (1) "sales to retail customers appear to have resumed a somewhat normal growth pattern"; (2) "sales to PJM appear to have leveled off to a large degree"; and (3) "PEPCO has substantially reduced its construction budget . . . ." The Commission's second premise is factually incorrect, as the net interchange revenues uncontestedly not only were forecast to but did in fact decline throughout 1975. Additionally, its first and third premise, while factually correct, do not contradict the substantial record evidence of continuing attrition.[30] It is clear, therefore, that what "appeared" to the Commission to be an abatement of

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[29] For a comparison of the various means used by other commissions to set realistic rates, see *Re Georgia Power Co., supra* n.22 (future test period accompanied by fully projected rate base used); *Re Central Maine Power Co., supra* n.22 (rolled-in test year utilized); *Re New England Tel. & Tel. Co.*, 22 P.U.R.3d 470 (1958) (test year updated for following 12 months); *Re Mountain States Tel. & Tel. Co.*, 8 P.U.R.3d 176 (1954) (estimates for the six months following the test period selected to compensate for attrition).

[30] Sales to retail customers did increase approximately 6% in 1975, but greater attrition occurred then than in 1974. It also is true that Pepco reduced its construction budget, but its investment in new plant remained substantial, and unit generation costs continued to increase, as expected.

attrition was no more than "the hope of a better life to come" by which "[p]resent confiscation is not atoned for". *West Ohio Gas, supra*, at 83.

VI. Construction Work in Progress and Materials and Supplies

Pepco's arguments pertaining to the Commission's refusal to adopt year-end figures for CWIP and M&S also are well founded. The only justifications offered by the Commission for its decision to use average 1974 data are that the accounts fluctuated widely, and that their amounts in December of 1974 "appear to be abnormally high." It also took the position that average amounts would be "more representative of the flow of dollars in and out of the accounts."

The justifications advanced do not support the Commission's decision. Wide fluctuations in CWIP are irrelevant for the purpose of determining the rate base. Any investment leaving CWIP enters Plant in Service, and thereupon is simply switched from one rate base account to another. To conclude that an end-of-period account "appears" to be high is not material to a proper consideration of the overall rate base. Moreover, while an average figure might better represent the cash flow over a definite period of time in the past, its predictive value, ascertained in a vacuum, is questionable at best, particularly in light of the inexorable increases in fuel costs.

The manner in which the Commission short-circuited Pepco's efforts to achieve meaningful rate relief is most glaringly illuminated by the treatment afforded the funds invested in the company's newest generating plant, Chalk Point Unit No. 3. This unit was under construction dur-

ing all of 1974, and the related investment was carried in the CWIP account. In May of 1975, construction was completed, and the related investment was transferred to the Plant in Service component of the rate base. The Commission, however, arbitrarily excluded substantial sums related to the new unit from the company's rate base not once, but twice.

Initially, as we have noted, the Commission prescribed average rather than year-end CWIP figures for inclusion in the 1974 rate base. By refusing to utilize the more representative year-end figures for CWIP, the Commission arbitrarily disregarded the substantial sums invested by Pepco in that new plant, and thereby excluded approximately $27.5 million from the District of Columbia rate base. This effected a resultant decrease in the utility's revenue requirement of some $5.5 million. Such a revenue deficiency more than offset the attrition allowance which resulted from permitting an end-of-period rate base for Plant in Service. The portion of the investment in CWIP that had been "averaged out" by the Commission simply was not permitted to earn a return. (To have allowed the use of a fully end-of-period rate base would have permitted Pepco to earn an additional return of $2.5 million—an amount which would have substantially reduced the $4.3 million earnings deficiency forecast by the Staff to result from the Commission's decision.)

In addition to effecting an unjust result, such a decision deviated from precedent. In both the 1970 and 1973 Pepco rate orders, the predecessor Commission sought to protect Pepco against attrition by discarding the traditional average test year rate base in favor of an end-of-period rate base. In so doing, the Commission hoped to give greater recognition to increased fu-

ture unit costs of generation arising from the company's construction program. Although the record revealed—and the present Commission's Staff recognized—that this method of combatting attrition had proven inadequate, the Commission chose to provide for even less relief directed towards counteracting attrition in the instant case than it had in the earlier cases.

In its second (and more costly) action regarding Chalk Point Unit No. 3, the Commission refused to recognize the known and certain change that occurred in May of 1975 when the $160 million in investment for that facility was transferred from the CWIP account into the Plant in Service account. By backing up to the end of 1974 for a determination of Plant in Service, and thus refusing to account for such a simple but major shift of funds, the Commission kept that $160 million from being able to earn a return as part of Plant in Service until the company's next rate case. In this way, the Commission dramatically built attrition into its ratemaking, in a manner which was patently arbitrary and unreasonable.

The Commission's principal Staff witness virtually admitted on cross-examination that his recommendation of this adjustment was rooted in sensitivity to public reaction.[31] By adopting that recommendation, the Commis-

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[31] He readily agreed with "the current Commission and Pepco practice with respect to the treatment of CWIP for rate-making" (*i.e.*, using end-of-period figures to compensate for attrition), and stated:

> Obviously, the ability to earn on the construction work-in-progress, and at the same time improve the cash flow, would obviously have an effect on the borrowing ability of the company.

The following exchange then occurred:

> Q. Now, if you don't feel that it is fair and reasonable to abandon the methodology because the dollar

sion destroyed the delicate balance between investor and consumer interests, sacrificing the long-range goals of both groups to what it apparently perceived to be the immediate pecuniary interests of the consumers. Commissioner Stratton accurately focused on this point in his dissent:

> If one concedes our agency expertise, the CWIP-averaging decision must be deemed to be an informed decision. Since it is clearly wrong, and the circumstances point to only one other explanation for it—namely, an expediency perpetrated in the interest of holding down rates it must be seen as arbitrary and is, on that basis, probably reversible error.

> amounts are substantially larger, . . . then, why . . . do you justify . . . the averaging of CWIP during the test period, on the grounds that you have done so in order to place the method employed by Pepco on an equal basis with the AFUDC [allowance for funds used during construction] Accounting Convention.
>
> A. This was a situation . . . whereby when Pepco came in for its increase, as you well know it attracted a great deal of attention. * * *
>
> I thought it would be appropriate even though the use of "averaging" even though the end-of-rate base [*sic*] is recommended, the use of the average for construction work-in-progress was unusual.
>
> I thought the times called for unusual treatment. That is the reason why we thought we would adopt it.
>
> . . . .
>
> We are separating it from attrition in this particular instance. In other words, we recognize it has to be used in the computation of attrition, but we separate it from the application of attrition to the rate base.

Obviously, for the Commission thus to "separate" CWIP from attrition is not merely to fail to compensate for attrition, but consciously to aggravate it.

Commissioner Stratton also emphasized his belief that the decision to adopt 1974 average investment in M&S was arbitrary and capricious, as the known and certain average investment in M&S for the more recent test year ended June 30, 1975, was $6.7 million higher than the obsolete figure adopted by the Commission. We agree.

VII. The Failure to Adjust for Known Changes of Record

From the standpoint of writing an opinion in a case such as this, it is inevitable for there to be an overlapping of some of the problems with which we must deal. Pepco's final allegation of error—presented as an alternative—asserts reversible error in the Commission's failure to adjust the 1974 results for three known and certain post-1974 changes of record. While our holding as to the proper test year essentially moots these contentions, we mention the three factors briefly.

The first involves the company's net receipts from PJM Interchange sales. During the calendar 1974 test year, the net interchange margin applicable to District of Columbia business was $17.3 million. The 1975 operating results which were received in evidence reveal that the net jurisdictional margin had declined by $7.6 million annually. Pepco demonstrated that the 1974 margin was unusually high, and the Commission acknowledged that "we see no evidence of record which persuades us that there will be a return to past normalcy in the near-term future in [PJM sales]," and that ". . . sales to PJM appear to have leveled off to a large degree. . . ."

Therefore, as the evidence demonstrated that the 1974 net revenue benefit to Pepco was unrepresentative of ex-

pected future margins, and as more recent data of better predictive value was available, the Commission unreasonably and arbitrarily failed to substitute the net interchange margin experienced during the test year ended June 30, 1975, for the 1974 margin.

The Commission also erred in not making the appropriate adjustments for the actual transfer of $160 million from CWIP funds to the Plant in Service rate base component for the Chalk Point Unit No. 3 which occurred in May of 1975 (as discussed above), and for the $5-7 million increase in the company's investment in M&S. These were known and certain changes of record which required no further testimony or cross-examination, and the Commission erred in disregarding them to the severe economic detriment of the utility.

VIII. The Remedy

On the basis of the Commission's arbitrary and unreasonable refusal to utilize the latest historical operating data of record and the ensuing denial to Pepco of an opportunity to earn either the overall 9.1% rate of return or the 13% rate of return on equity found required to attract capital, we must sustain Pepco's appeal, vacate Order No. 5739, and remand the case to the Commission with instructions to remedy its legal defects. Our authority to do so is delineated in D.C. Code 1973, § 43-705, which states in relevant part:[32]

> Upon the conclusion of its hearings of any such appeal the court shall either dismiss the said appeal and affirm the order or decision of the Commission or sustain the appeal and vacate the Commission's order or decision. In either event the court shall accompany its order by a statement of its reasons for its action and in the case of the vacation of an order or decision of the Commission the statement shall relate the particulars in and the extent to which such order or decision was defective.

[32] We previously have held that the appeals provisions of the Administrative Procedure Act, D.C. Code 1973, § 1-1510 (1), are superseded by this and other relevant sections of the Code which deal with public utilities. *See Chesapeake & Potomac Tel. Co. v. PSC*, D.C.App., 339 A.2d 710, 713 (1975).

On remand, the Commission first should calculate modified rates according to the Staff's own ratemaking formula based upon the data submitted for the test year ended June 30, 1975, and then calculate the revenue losses improperly experienced by Pepco during the period that Order No. 5739 was in effect.[33] Absent the atypical

[33] Order No. 5739 became effective on December 13, 1975, and expired on December 13, 1976, when revised rates authorizing an additional $29.4 million in revenues became effective by means of Order No. 5849. The revised rates were set pursuant to another ratemaking proceeding which, as predicted, followed close on the heels of the instant case.

The Commission has urged, in a Motion To Dismiss filed on January 14, 1977, that the issuance of the revised rates in Order No. 5849 renders moot and impractical the question of relief in the instant case. However, Pepco was never allowed to recoup the revenue losses experienced as a result of the Order at issue in this case. The question of relief therefore is still a contested issue, and the Motion To Dismiss is denied.

Additionally, even if the Order here under review technically were moot, it presents issues of a continuing nature long recognized as an exception to the mootness doctrine. *Roe v. Wade*, 410 U.S. 113 (1973); *Southern Pacific Terminal Co. v. ICC*, 219 U.S. 497 (1911). This exception applies most broadly in cases reviewing administrative agency actions. *See Golden Holiday Tours v. CAB*, 174 U.S.App.D.C. 292, 294, 531 F.2d 624, 626 (1976). Pepco's appeal presents sub-

weather patterns experienced in 1976-'77, we would direct the Commission then to devise a means for restoring to Pepco the revenues which it improperly has been denied. A reasonable means of accomplishing this so as to assure Pepco's continued ability to perform its vital service to the public could be the application of a temporary surcharge to the rates currently in force in order to amortize the calculated loss over a period of time. In this way the delicate balance between the interests of investors and consumers could be maintained. *See Hope Natural Gas, supra*, at 603.

The nature of such relief would remain prospective. In calculating the lost revenues, the Commission will place itself in a position to provide the rate relief it legally was bound to give at the time of its now-vacated opinion of November 12, 1975. To do otherwise would be to give perpetual legal effect to an unlawful order, and to unnecessarily and unwarrantedly penalize Pepco, its investors, and indeed its customers for the passage of time necessitated by appellate review of that unlawful order.

The Commission opposes the imposition of any remedy involving a calculation of past revenue losses, contending that such relief improperly would constitute retroactive ratemaking. *See Payne v. Washington Metropolitan Area Transit Commission*, 134 U.S.App.D.C. 321, 330, 415 F.2d 901, 910 (1968). While we recognize the general principle precluding a utility from charging higher rates in the future in order to recoup past losses, that concept does not bar the relief to which Pepco appears to be entitled.

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stantial legal questions that not only call for remedial action in and of themselves, but which readily are capable of repetition in future cases.

The losses sought to be recovered in *Payne* were suffered pursuant to an interim order issued during the rate proceeding, but before any determination on the issue of a fair rate of return was made. *Id.*, at 324, 415 F.2d at 904. The *Payne* court emphasized that the losses were not shown to be materially different from those projected in the interim order:

> "[P]rophecy, however honest, is generally a poor substitute for experience," [*West Ohio Gas, supra*, at 82] and actual operating results showing losses greater or less than those the Commission had projected might properly have affected the Commission's conclusion as to the need for a fare increase or the amount of increase needed. [134 U.S.App.D.C. at 331, 415 F.2d at 911.]

In the instant case, the losses occurred after a fair rate of return had been determined in Order No. 5739, and the lost revenues have been shown, by abundant evidence of record, to be the result of arbitrary and unreasonable Commission rulings.

Our conclusion is consistent with that set forth in *Chesapeake & Potomac Telephone Co. v. Public Service Commission, supra*, 330 A.2d 236. In that case, the losses at issue were experienced between the release of an interim rate relief order, in which the rate of return was determined, and the final order. Those losses, we said,

> were not past losses as of the time the 8.8% rate of return was determined, and they were not taken into consideration in setting that rate. The Commission's interim proposal . . . authorized prospective relief only . . . . Past losses were not accorded any consideration in establishing the rate of return for the period in ques-

> tion and the order did not provide for the Company to recoup losses in revenues, if any, experienced during that period. [*Id.*, at 240.]

Likewise, in the instant case, the losses to be calculated on remand were not past at the time of the opinion in which the 9.1% overall rate of return and the 13% rate of return on equity were established, nor were they considered in setting those rates. The Commission issued its final order increasing revenues to compensate for anticipated future deficiencies in earnings. The losses to be calculated thus are essentially like those in the *Chesapeake & Potomac* case, and would not constitute a basis for retroactive ratemaking.

In reviewing a similar proceeding in which a rate of compensation for a past period was determined, the circuit court distinguished the result of an isolated past sale of capital assets (which could not be included in a calculation of future rates) from compensation for the service performed by the regulated company (which could be so included), regardless of whether the service was past or future. *Summerfield v. Civil Aeronautics Board*, 92 U.S.App.D.C. 248, 251-52, 207 F.2d 200, 203-04 (1953), *aff'd on other grounds sub nom. Western Air Lines v. Civil Aeronautics Board*, 347 U.S. 67 (1954). Referring to the general view that ratemaking is inherently a prospective concept, the court stated:

> But we are impressed by the practical aspects of the situation. In this instance the Board was in fact looking at a period which had passed. The actual facts as to revenues and expenses for that period were known. * * * In saying that the Board was looking at a past period we are not departing from the rule in the T.W.A. case. [*Transcontinental & Western Air, Inc. v. Civil*

> *Aeronautics Board*, 336 U.S. 601 (1949).] The period began when the petition for the ratemaking was filed . . .; as of that date the ratemaking was prospective. When the Board got around to making its findings and decision the period [of service] was past. It is to the latter actuality that we refer. [92 U.S.App.D.C. at 252, 207 F.2d at 204.]

The ordinary purpose of a utility rate, the court observed,

> involves reimbursement for expenses incurred in performing the service, return on the investment used in the service, and a reasonable profit on the transaction. This much is due whether the service is past or future. [*Ibid.*]

In the instant case, the period for which the revenue losses are to be calculated came not only after the filing of the application for increased rates, but after the effective date of the order authorizing prospective rates. The lost revenues for which Pepco may be entitled to recoupment became due to the company while the disputed and inadequate rates were in effect. They therefore are not analogous to past losses bearing no relation to expected future revenues which play no valid part in a prospective ratemaking proceeding.

Regarding the suggested method of collecting the losses, the Supreme Court, under comparable but reversed circumstances, ordered a refund of excessive amounts collected during the course of a rate proceeding in *Federal Power Commission v. Tennessee Gas Transmission Co.*, 371 U.S. 145 (1962). The circuit court also has ordered distribution to the rate payers of funds resulting from invalid rate increases previously granted by the Commission. *Washington Gas Light Co. v. Baker*,

supra, 88 U.S.App.D.C. at 127, 188 F.2d at 23. Reviewing courts with the power to direct refunds on the basis of invalid orders also have the concomitant power to direct consideration of the possible need for surcharges on the basis of such orders, for to function otherwise would be to permit the perpetuation of demonstrably confiscatory rates, rendering appellate review but a meaningless exercise.

Time and the weather, however, may have tempered the need for a surcharge to compensate the company for those aspects of the rate order which we hold to have been confiscatory. The differing views which have resulted in a majority, a dissenting, and a concurring opinion in this case have permitted a regrettably lengthy period to elapse on appeal. We judicially note that the summer of 1976 was moderately warmer than normal, and that the winter of 1976-'77 was uniquely cold. These and other factors may have led to unexpectedly high revenues for Pepco for those months, which, equitably, may have offset the need for a surcharge. In the computation on remand of the company's improperly proscribed revenue shortfall attributable to the arbitrary diminution of its rate base in the order which we vacate herein, we sanction as a possible offset thereto what may have been unusually high revenues experienced by Pepco during that period. Of course, at this time we have no way of knowing what the facts will prove to be; that must remain for the parties to demonstrate and for the Commission to determine on remand.

Vacated and remanded.

YEAGLEY, *Associate Judge*, dissenting: Because I view the Commission's order here as the culmination of a conscientious and careful analysis of the extensive evidence in the case incorporating findings and conclusions on each issue that are amply supported in the record, I must dissent. While one could disagree with some of the Commission's conclusions, none is either arbitrary or capricious.

The majority's severe criticism of the Commission's opinion and order might leave the impression that the Commission denied the company any increase in revenues whatever when in fact the Commission authorized a substantial increase in rates so as to provide the company with $27,657,000 additional annual revenue. Particularly troublesome to me is the remand of the majority directing the Commission to establish a substantially larger rate base in conformity with company figures as of June 30, 1975, so as to provide retroactively a substantial increase in company revenues. In my view this remand goes well beyond the bounds of legitimate agency review.[1]

Contrary to repeated assertions by the majority, the Commission has in fact set forth quite clearly in its 52-page final opinion and order a discussion of the evidence and its reasoning on the relevant issues. Accordingly, I must divorce myself from the effort to label the decision as "arbitrary and capricious."

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[1] D.C. Code 1973, § 43-706, provides:

> In the determination of any appeal from an order or decision of the Commission the review by the court shall be limited to questions of law, including constitutional questions; and the findings of fact by the Commission shall be conclusive unless it shall appear that such findings of the Commission are unreasonable, arbitrary, or capricious.

I. Assertions of Error

The majority summarizes the asserted errors it finds in the order appealed from as follows:

> Examination of the elements of the opinion reveals several conclusions which are arbitrary, capricious, and not based on substantial evidence of record. These include the Commission's refusal to utilize the most recent test period in the record, its failure to account for continuing attrition, and its refusal to recognize certain known changes which occurred after the close of the originally proposed calendar 1974 test period. [Draft opinion at 7.]

The majority holds that even though the test year on which the company based its application was calendar year 1974, it was arbitrary and capricious, and therefore error for the Commission not to have used the company figures revised as of year-end June 30, 1975, as the test year. Since, as will be seen, the Commission discussed and used many of the company's 1975 figures, the majority appears to be standing on the proposition that it was error as a matter of law for the Commission not to have used all of those figures thereby effectively changing the test year to June 30, 1975, even though such data was not put in the record until it came time for rebuttal testimony. I submit that at that juncture it was clearly a matter of discretion for the Commission. It is far from clear to me just what indicia there are to justify the majority's application of the adjectives "arbitrary and capricious" to that determination. The mere affixing of such a label cannot confer validity on an appellate ruling that is wholly unsupported and unjustified. An examination of each of the Commission's findings and conclusions reveals that none was arrived

at arbitrarily, but rather only after thoughtful consideration of the evidence and of the arguments on each side.

The majority also concludes that the rates set would deny the company an opportunity to earn a fair rate of return. I submit that this is pure speculation. The majority does not support its conclusion with any computation or projection or other justification except to indicate its complete acceptance of the company's evidence and the estimates of its witnesses, not an insignificant part of which was contested by intervenors and staff witnesses [2] and rejected selectively by the Commission.

II. The Standard of Review

The majority recognizes that the power to make rates was delegated by Congress to the Commission, but forgets that as an appellate court our review of a utility commission order is strictly limited. It is the narrowest judicial review in the field of administrative law. K. Davis, Administrative Law of the Seventies § 29.00, at 647 (June 1976); 2 F. Cooper, State Administrative Law 756-72 (1965).

"[T]he scope of our review of the Commission's actions is 'limited to questions of law . . . and the findings of fact by the Commission shall be conclusive unless it shall appear that such findings of the Commission are unreasonable, arbitrary or capricious.'" *Watergate Improvement Associates v. Public Service Commission*, D.C.

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[2] *See*, for example, P.C. Exhibit A, 39-43; P.C. Exhibit 10; Commission Order at 25-26; Staff Exhibit 4, 24-28; transcript at 1111, 1112, 1457-1484, 2516; Staff Exhibit 4, sch. A; GSA Exhibit 21 at 4; GSA Exhibit 22 at 1-3; GSA Exhibit 22A at 11-13; GSA brief with the Commission at 4, 5, 10, 25, 29; and P.C. brief on appeal at 11-17.

App., 326 A.2d 778, 783 (1974), *quoting* D.C. Code 1973, § 43-706. In an appeal by an intervenor of an earlier Pepco rate increase, Judge Harris, speaking for the court said:

> Arbitrary action, however, is action not based on facts or reason. . . . The burden upon petitioner is not merely to put forth an acceptable alternative but rather to demonstrate clearly and convincingly a fatal flaw in the action taken. . . . Petitioner has not met that burden. He simply asserts a difference of opinion with the Commission. [*Goodman v. Public Service Commission*, D.C.App., 309 A.2d 97, 101 (1973) (citations omitted).]

Four years ago when intervenors contested a $12,000,000 rate increase for the company, this court quoted with approval the guiding rule for appellate review of utility agency orders as set forth in *Williams v. Washington Metropolitan Area Transit Commission*, 134 U.S. App.D.C. 342, 362, 415 F.2d 922, 942 (1968), *cert. denied*, 393 U.S. 1081 (1969):

> Our role as a reviewing court is not to make an independent determination as to whether fares fixed by the Commission are just and reasonable, but rather to insure that the Commission, in exercising its rate-making power, has acted rationally and lawfully. Our function is normally exhausted when we have determined that the Commission has respected procedural requirements, has made findings based on substantial evidence, and has applied the correct legal standards to its substantive deliberations. [*Telephone Users Association v. Public Service Commission*, D.C.App., 304 A.2d 293, 296 (1973), *cert. denied*, 415 U.S. 933 (1974).]

That statement of the law is reduced to a nullity by today's opinion. The final opinion and order of the Commission here easily meets the test of the *Telephone Users* case. It could well be one of the most thorough and comprehensive decisions this court has received from an administrative agency in the District of Columbia.

The basic disagreement I have with the majority opinion is in its treatment of the facts and in its application of the law to the facts. For example, the majority applies the standard of "arbitrary and capricious" in circumstances where the transgressions of which it complains are no more than differences in judgment. One who examines the order will find that the Commission did not pick its conclusions out of thin air. It did not arrive at conclusions except after noting evidence upon which the conclusion could be based and in each instance the Commission set forth supporting reasons. "The court's responsibility is not to supplant the Commission's [balancing] of [the factors involved] with one more nearly to its liking, but instead to assure itself that the Commission has given reasoned consideration to each of the pertinent factors." *Permian Basin Area Rate Cases*, 390 U.S. 747, 792 (1968).

As long as there is substantial evidence to support a reasoned conclusion of the Commission we must affirm. *Watergate Improvement Associates v. Public Service Commission*, *supra* at 783-84. *See also Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 416 (1971).

The majority places much reliance on *West Ohio Gas Co. v. Public Utilities Commission*, 294 U.S. 79 (1935) and *New York Telephone Co. v. Public Service Commission*, 29 N.Y.2d 164, 272 N.E.2d 554, 324 N.Y.S.2d 53 (1971). In the *New York Telephone Co.* case an interim rate increase was ordered but it was followed by an interim par-

tial reduction. When it developed that the company's actual earnings under those orders yielded a significantly lower return than the Commission had said was reasonable, even lower than the company's earnings prior to the application, the company asked that the hearings be reopened before the final order was entered. Although the Commission did not deny that the rates were confiscatory, the majority of Commissioners refused to reopen the proceedings suggesting instead that a new rate proceeding be initiated. The appellate court held that: "Where there is a great disparity between the predicted rate of return found necessary by the Commission and the return actually earned,[3] a suitable adjustment should be made to reflect the attrition trend or the erosion that has taken place." *Id.* at ____, 272 N.E.2d at 557, 324 N.Y.S.2d at 56.

In the instant case we have neither a concession that the rates are confiscatory nor a blanket refusal by the Commission to consider updated figures. In fact the 1975 data were considered and many were used by the Commission as will be detailed, *infra*. The *New York Telephone Co.* case is not authority for today's holding that it was arbitrary and capricious for the Commission not to have changed the test year at the conclusion of the hearing.

In *West Ohio Gas Co.*, the Commission confined itself to operating data for 1929, and refused to consider available data as to actual operations for 1930 and 1931. It is in this context that the Court said, as quoted by the majority:

> To shut ones eyes to [the latest available figures] altogether, to exclude them from the reckoning, is as much arbitrary action as to build a schedule upon guesswork with evidence available. [*Id.* at 81-82.]

[3] If the majority would not blind itself to "the return actually earned" by Pepco in 1976 under the new rates, it would have to discard the label of "confiscatory." *See* section V., *infra*.

In the instant case the Commission was not using a test year two years old and did not exclude the updated figures "from its reckoning."

When a gas company sought to enjoin allegedly confiscatory rates set by a state regulatory commission, the Supreme Court in affirming a dismissal of the complaint said: "That question [the constitutional question] is whether the rates as fixed are confiscatory. And upon that question the complainant has the burden of proof and the court may not interfere with the exercise of the state's authority unless confiscation is clearly established." *Los Angeles Gas Co. v. Railroad Commission of California*, 289 U.S. 287, 305 (1933).

When the Fourth Circuit reversed a decision of the Federal Power Commission which had reduced rates of a gas company, on the grounds that the Commission had failed to consider certain costs in the rate base and had improperly computed depletion and depreciation, the Supreme Court held that a showing of a great deal more was required if the courts were to reverse such an order.

The Court observed rather sensibly:

> Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, even though they might produce only a meager return on the so-called "fair value" rate base. . . . And he who would upset the rate order base under the Act carries the heavy burden of making a convincing showing

> that it is invalid because it is unjust and unreasonable in its consequences. [*Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 602, 605 (1944).]

Applying the Supreme Court's standard in *Hope*, to the facts in this case, it becomes clear the majority has failed to carry its "heavy burden" of showing that the $27,657,000 increase in revenues awarded the company by the Commission is so inadequate that the company would not be able to operate successfully, and that it would thereby lose its financial integrity and its ability to attract capital. That conclusion made by the majority is not justified by the facts of this case. I would note in this regard that Pepco's remarkably improved financial standing at the end of 1976, after one year of experience under the new rates[1] is devastating testament to the fallacy inherent in the majority's speculation that the increased rates would be confiscatory.

III. The Test Year

Contrary to the contention of the majority that it was arbitrary not to have used a June 1975 test year in arriving at a fair rate base, it can be demonstrated there is no justification whatever on this record for the company to now contend that the Commission erred in using the 1974 test year with modifications being made, as warranted, for the June 1975 data. As will be seen, it was a matter properly left by the parties on the record to the discretion of the Commission and consequently is not a matter to be taken over by an appellate court.

In the application for a rate increase filed by the company it asked that it be based on a 1974 calendar test

[1] *See* section V., *infra*.

year and it supplied actual figures for the first eight months of 1974 augmented with detailed estimates for the remaining four months. As figures for the company's actual operations for those four months became available they were supplied by the company. Thirteen different parties intervened. After cross-examination of company witnesses was completed and as the respondent and intervenors were completing their testimony in opposition, the company, on Friday, July 18, 1975, filed proposed rebuttal testimony of its Sr. Vice-Pres.-Finance, with two exhibits which set forth financial data reflecting operating results from January 1 through June 30, 1975. (Company exhibits G and 14.) That witness testified on those figures "in rebuttal" on Wednesday, July 23rd.

The following was brought out during cross-examination of that rebuttal witness by counsel for the Commission:

> Q. Mr. Davis, are you proposing a new test year for the Commission to use in this case?
>
> A. I have indicated in the testimony that we think it is important to place this information on a test year revenue requirement basis before the Commission. *Now we are not—not suggesting a substitution of the June 30 year for the December 31 year*, but I do ask, or do suggest in my rebuttal testimony, and I would ask, that the Commission take note of this information and apply it in reaching the conclusions in this case . . . . [Emphasis supplied.]

The majority quotes and relies on the testimony of Pepco's President, J. Reid Thompson, who testified in rebuttal that same day wherein he stated at first: "I

would urge the Commission to base its results on the June 30 figures."

However, Mr. Thompson changed his position when cross-examined by People's Counsel, but the majority has ignored this damaging testimony in its effort to brand the Commission with arbitrariness in not changing to a June 30, 1975 test period. Mr. Thompson testified as follows:

> Q. . . . You are not suggesting a new period, are you? You still want your end of period rate base considered in this case December, 1974. You are not requesting an amendment of that at this time?
>
> A. I don't want to get bogged down in semantics or play a game.
>
> Q. Well, let's not get bogged down. You are a lawyer. Let's understand—
>
> A. What I am saying to this Commission is trying to arrive at the truth here as to what is a fair and reasonable rate of return. I am suggesting to this Commission that if it can be done in the light of their understanding and their responsibility without delaying this case, without any further opening the record, that they should adopt a June 30 test year. I am suggesting precisely that, *but I am suggesting that, however, if it requires a reopening of the record to lay in a case, that they don't do that.* Rather, grant an additional attrition allowance to take into account June 30 figures. [Emphasis supplied.]

His final position then seems to be clear that the company was not insisting on a change in the test year, but was urging the Commission to take into consideration the June 30 figures. Since the case was filed and tried on a 1974 test year, it is apparent that President Thompson was necessarily leaving to the discretion of the Commission the decision as to how much consideration to give the new data. Mr. Thompson concluded his testimony by saying:

> . . . I would urge upon this Commission the urgent necessity for prompt action on the case after it is completed, with the same alacrity with which you have conducted the hearings, Madam Chairperson.

When the hearing was terminated there was no question on the record but that 1974 was still the test year, that the company believed the Commission should give great consideration to the updated figures but that any further delay to explore the new data was not acceptable to the company. Accordingly, respondent and intervenors, not having had time to obtain in depth familiarity with the new data, did not cross-examine Mr. Davis in detail on the new information nor did they recall their witnesses to testify regarding the updated 1975 figures as would have been their right had the Commission announced that it was adopting a new test year. The earlier testimony of all witnesses of the respondent and of all witnesses for the intervenors had dealt only with the 1974 calendar year data. That is what all of the first 2600 pages out of a total of 2900 pages of testimony were all about. When wholly new data for the test year is furnished at the end of a case, procedural due process as well as basic considerations of fairness require an opportunity for all parties to review it and

cross-examine the utility's witnesses regarding it and to offer further evidence in surrebuttal.

In view of the testimony of the company's own officers, I find it surprising it would claim subsequently on petition to the Commission for reconsideration that the use of June 30, 1975, as a test year was an issue in the case. More importantly, I must confess a complete loss to understand how, on such a record, the majority here can defend, let alone advance, such an argument. I would hope that the majority does not intend to suggest that a position taken by a party on the record during a hearing, or that a stipulation entered into, or a representation made to an administrative tribunal, is not something advanced in good faith and to be relied on by the Commission.

It strikes me as somewhat misleading for the majority to suggest an inference should flow from the fact (page 29) that "[n]o objection was made to the admission of the testimony and its accompanying exhibits," (referring to the June 30, 1975 figures) when there was patently no cause for an objection after the Financial Vice-President of the company who presented the new financial data, flatly stated that the company was not requesting a change to a June 30, 1975 test year.

Furthermore, in view of this record, the majority's statement that: "It was only after the Commission issued its opinion, and Pepco appealed that arguments were advanced against utilizing the most recent actual data" is equally vulnerable. The objections were forthcoming at that point because of the strong arguments of the company raising this issue in its petition for reconsideration. In oral argument to the Commission Pepco did not raise any question about a June 30, 1975 test year. Instead its lawyers appeared to assume that a 1974 test year was to be used.

Company counsel, Carl D. Hobelman, said for example:

> Now what solutions to the attrition problem exist?
>
> The one that's traditionally been used by this Commission and most others is year-end rate base, and we think that if this Commission is going to stick wi[illegible] the 1974 test period that that's a minimum.

Edward A. Caine, the other Pepco counsel who argued, flatly stated, while discussing the possible effect of company land transactions, "[t]he test period in this case is 1974." The case having been filed and tried on a 1974 test year up to almost the last day, the Commission had every right to use a 1974 test year, utilizing the 1975 updated figures as appropriate in its discretion. None of the authorities cited by the majority on this issue pose a comparable factual situation.

However, the Supreme Court of Arkansas has had occasion to address a strikingly similar situation. In *Arkansas Power & Light Co. v. Arkansas Public Service Commission*, 289 S.W.2d 668, 673 (Ark. 1956), where the Commission refused to consider information after the end of the test year, the court held:

> As to the testing period, it clearly appears to us from the record that the appellant, itself, in its rate application chose the testing period, and the Commission accepted appellant's choice. Appellant's application was tried throughout on the theory that the test period should be the 12 months ending March 31, 1954. In other words, March 31 was to be the cut-off period of this pattern year.

The reasoning of the Arkansas decision is unassailable and compelled by reasons of fairness.

IV. Attrition and Use of 1975 Data

The majority contends that "the failure to account for continuing attrition" was arbitrary. However, it is patently clear that the Commission did not fail to account for attrition. The final order of the Commission is replete with comments that demonstrate its careful consideration of the evidence of attrition. It will be noted that the Commission plainly found in its order at pages 24 and 25:

> In short, we are persuaded that attrition is a phenomenon that is still with us, and we will therefore now, as we have in the past use an end of period rate base, with appropriate adjustments, in order to compensate for the presence of attrition.

The real problem here is that the majority disagrees with the extent of attrition that the Commission recognized in its computation. That, of course, is simply a difference of judgment and is not demonstrably arbitrary or capricious. The best evidence upon which to conclude whether the Commission acted arbitrarily is to be found in a reading of its final order. Because I believe the final order to be self-explanatory, copies of pages 23-28 inclusive of the order are attached hereto in an appendix to this dissent, as a typical sample of the order to assist the reader in judging whether the Commission acted reasonably or arbitrarily.

Some years ago, the practice of the Commission had been to use the average rate base for the test period. In order to combat the effects of attrition, an exception to the general rule was recognized so that when attrition was found to exist the ratemaking authority could use a company's year-end rate base to compensate for

it. *Telephone Users Association v. Public Service Commission*, *supra* at 298, *citing City of Lynchburg v. Chesapeake & Potomac Telephone Co.*, 200 Va. 706, 711, 107 S.E.2d 462, 469 (1959). *See also Goodman v. Public Service Commission*, *supra*. This is exactly what was done in the instant case. The Commission chose to follow this court's suggestion in the *Telephone Users* case and, by and large, used the end-of-the-year rate base making adjustments when necessary for abnormally large end-of-the-year figures. It also made other adjustments in light of changes appearing in the company's June 30, 1975, data.

A regulatory commission bases its final order on a consideration of all relevant data available for the test year. When updated figures following the test year are offered late in the hearing as part of the company's rebuttal testimony, it must necessarily fall to the discretion of the Commission to decide how much consideration shall be accorded such evidence and to determine which items would seem to have a significant bearing on its projection of future operations. He who would upset its decision carries a heavy burden.

The Commission carefully examined the data for 1975 and began its consideration of the effect of the 1975 figures by noting: "Although 1975 operating data, of which we may take official notice, indicates a resumption of growth trend in retail kilowatt hour sales, it appears that the over 60% reduction in PJM sales is continuing . . . ." (Referring to Pennsylvania, New Jersey, Maryland Interchange sales [order at 6 and 7].) With regard to its consideration of embedded costs of debt capital the Commission noted that the experts agreed that the end-of-year figure for 1974 should be adjusted to reflect the retirement in August 1975 of $10 million in debt securities. (Order at 15.) It observed: "In determining

the cost of debt that we have used in reaching our rate of return conclusion, we have recognized and accepted known changes from the December 31, 1974 figure." It noted that a $50 million debt issue anticipated in 1975 by two witnesses was not made, but that Pepco had chosen instead to meet its 1975 capital needs through short-term borrowings. Accordingly, it adjusted the 1974 embedded debt cost to reflect only the August 1975 debt retirement. The resulting figure arrived at of 6.97% was rounded to 7% in recognition that at "current costs" (1975) of debt capital, any new debt issue by Pepco will necessarily increase the embedded figure (order at 16). In considering the cost of preferred stock, the Commission took into consideration the cost of the company's preferred stock sale in April 1975 and that it involved a convertible preferred. (*Id.* at 16 and 17.) It concluded this part of its discussion by saying: "While we are reluctant to attempt to predict the future costs of debt and preferred stock, we cannot ignore current costs [1975]. We will therefore adjust the mathematically arrived at 9.05% rate of return to 9.1%, a feature which in our judgment is just and reasonable under today's economic conditions." (*Id.* at 20.)

Although Pepco sought a 9.75% rate of return it has not contested the rate set by the Commission. Indeed it is the highest rate I have noticed in the reported cases.

In regard to attrition the Commission said:

> The point is made by PEPCO that use of an end of period rate base will only partially reflect the "attrition" in earnings that has taken place since our 1973 PEPCO decision. We are not persuaded, however, that the decline in earnings has been due solely to attrition, but has in large part been due to the drop in sales noted

> previously. Since sales to retail customers appear to have resumed a somewhat normal growth pattern [in 1975], and since sales to PJM appear to have leveled off to a large degree, [1975] and since PEPCO has substantially reduced its construction budget [for 1975], it appears reasonable to conclude that attrition in the future may play a less significant role than it has in the past. [*Id.* at 25, 26.]

The "drop in sales" refers to the dramatic effect of the 1974 national energy crisis which resulted in a marked drop in sales of electricity as a result of the emphasis by the government and consumer groups on the need to conserve energy.

In discussing CWIP and M&S the Commission said:

> The record shows wide fluctuations in these accounts over time and a substantial increase in fuel inventories in 1974, resulting from stockpiling due to the unusual fuel market in that year. The amounts at the end of the period in both accounts appear to be abnormally high. In view of PEPCO's projected reduction in its construction program and the reduction in fuel inventory in 1975, we do not believe that the end period figures can be called representative of anticipated future conditions. The adjustment of materials and supplies is consistent with the Commission's treatment accorded to this item in Formal Case No. 610. [Order at 25-26.]

Such thoughtful consideration of the relevant factors throughout the Commission's opinion precludes a holding that its order was arbitrary. As was said in *Goodman v. Public Service Commission*, 162 U.S.App.D.C. 74, 82, 497 F.2d 661, 669 (1974): "Since the Commission chose

between alternatives and achieved a reasonable result, we cannot disturb [its] findings."

The company and the majority opinion both emphasize the point that the Commission did not include the full December 31, 1974, figure of $359,000,000 [5] for construction work in progress (CWIP) instead of the weighted average used by the Commission of $284,000,000. This is a major contention of the majority which asserts that the Commission's act in arriving at this figure was not merely an error of judgment but was arbitrary and capricious. I do not find this claim to be supported in the record. There is substantial evidence, as will be seen, to support the Commission in its decision to use the weighted average. The Commission was not faced with the simple question of whether or not to accept the company figures and the company's method of computing the rate base. It had to consider all of the evidence on both sides including conflicting expert testimony and the arguments of intervenors against using full, face value, year-end CWIP. *See* note 1, *supra*.

The Commission was well aware that CWIP by its nature provides no service for the public nor any income for investors. In only a very few jurisdictions, including the District of Columbia, is CWIP included in the rate base.[6] If it is included, it is for the purpose of providing the investor with a return for that part of his funds which are currently tied up in nonproducing plants. Many jurisdictions instead of using a figure for CWIP, use a figure that allows for funds used dur-

[5] That figure represents over 29% of Pepco's gross utility plant. (Testimony of J. McCabe, III, P.C. Exhibit C at 36.) CWIP formed only 9% of the rate base in 1972 and the average for 1970-1974 was 13.17% (P.C. Exhibit M at 3).

[6] Tr. at 1501.

ing construction (AFUDC), (Tr. at 1501; Tr. at 1116; Pepco Exhibit 6, at 7; People's Counsel brief at 21), or a figure that capitalizes the interest on funds used in construction. When new plants become operational and move out of CWIP into plant in service, they become revenue producing for the company after which time the investor must begin to bear the risk of profit or loss.

In considering this problem, the Kansas City Corporation Commission said:

> If plant under construction were to be included in the rate base upon which a fair return is computed, equity would require inclusion also of the estimated additional revenue produced by such construction as operating revenue for the test period. Otherwise, existing telephone users would be forced to pay a return on property constructed for future subscribers with the result that when these future customers begin to receive service, the applicant would derive a double return on the cost of such construction." [*In re Southwestern Bell Telephone Co.*, 98 P.U.R.3d 30, 38 (1973).]

The evidence here indicated that during 1974 there had been an unusually large flow of dollars into CWIP from $197,000,000 on December 31, 1973, to $359,000,000 on December 31, 1974. In comparison the CWIP for year-end 1972 was only $95,000,000. The anticipated annual average through 1977 was predicted to be $288,000,000 (Staff Exhibit 4, at 28).

Since Pepco operates in Maryland and Virginia as well as the District of Columbia, only those percentages of company figures properly allocated to the District of Columbia operation are used in computing the rate base for the District. For example, the figure for District

of Columbia plant in service is computed by taking 44.82% of the total plant in service. Consequently, the company originally arrived at a figure of $657,634,000 or 44.82% of the total plant of $1,467,207,000.

Likewise, in computing CWIP only that part of the total figure attributable to the District of Columbia operation is used. Of the total of $377,508,000 claimed originally by the company, it allotted only $155,863,000 in its computation of the District of Columbia rate base or 41.29%. Pepco Exhibit 9, W 29 and W 30.

The staff used the same percentage figure for plant in service but allocated only 36.69% of total CWIP to the District of Columbia. *See* Staff Exhibit 4 SM-2, Sch. A, p. 1. On the other hand, the staff allocated 53.64% to the District of Columbia operation for plant held for future use. *Id.* The lower figure for CWIP may result from the fact that Chalk Point III, then under construction, is located in Aquasco, Maryland. Pepco Exhibit 8, at 2-3.

People's Counsel, citing examples of where only 60% of CWIP was used in some jurisdictions, recommended that the Commission adopt the rule followed in others that allow CWIP only up to 10% of the useful plant value. (People's Counsel Exhibit C, at 38.) The League of Women Voters asked the Commission to return to its former policy still followed by a great many regulatory bodies of excluding CWIP altogether from the rate base (brief at 6).

In view of the unusually high year-end figures, the General Services Administration urged the Commission to use a weighted average figure for CWIP, as did the Commission staff. It argued that the high year-end figure should be adjusted to normalize it to reflect conditions

that may reasonably be expected to be experienced during the period the rates will be in effect (brief at 5).

It added that Pepco's proposed amount of $88,177,000[7] for materials and supplies (M&S) is clearly excessive as demonstrated throughout the record." (Exhibit G at 5, brief at 4.)

The principal Staff witness, a recognized expert whose qualifications were unassailed, testified that:

> I do believe the rate base should be representative of what will take place in the future, and I think the averaging method for construction work in progress does just that.
>
> It puts construction work in progress on a basis that we can anticipate will occur in the future and will be more representative of what is going on.
>
> At the same time, we get the flow of dollars into the construction program as if it were on an interest during construction or AFUDC basis. [Tr. at 1458.][8]

The Commission concluded at page 26 of its order:

> We have given most serious consideration to all of these recommendations. We are disposed to agree with our Staff and accept Mr. Manheimer's recommendation for the use of an average amount of construction work in progress and an

[7] Only 42.91% of this figure would be applicable to the District of Columbia operation.

[8] The company itself admitted that Pepco's 1975-1978 construction budget was drastically slashed due to changed forecasts of customer demand over the next several years (brief at 9).

> average amount in the materials and supplies account in rate base as more representative of the flow of dollars in and out of the accounts. The record shows wide fluctuations in these accounts over time and a substantial increase in fuel inventories in 1974, resulting from stockpiling due to the unusual fuel market in that year. The amounts at the end of the period in both accounts appear to be abnormally high. In view of PEPCO's projected reduction in its construction program and the reduction in fuel inventory in 1975, we do not believe that the end period figures can be called representative of anticipated future conditions. The adjustment of materials and supplies is consistent with the Commission's treatment accorded to this item in Formal Case No. 610.

That reasoning seems to me to carry considerable logic and to be more than adequate to defeat any contention that the decision as to CWIP was arbitrary.

I agree with the Corporation Counsel's contention that in exercising its ratemaking responsibility the Commission is not bound to use any particular methodology, nor is it bound to adopt any particular alternative proposed. *Goodman v. Public Service Commission*, *supra*.

In *Goodman* the court held that:

> In its ultimate determination of future revenue requirements, the Commission had a choice of two figures: 1) the average values applying throughout the test-year ("weighted" rate base); or 2) the values on the last day of the test-year ("end-of-period" rate base). [*Id.* at 82, 497 F.2d at 669.]

Until today's decision the correctness of that proposition has never been doubted by the courts in this jurisdiction.

V. 1976 Operating Results Under the December 1975 Rate Order

Since the order herein setting increased rates became effective in December 1975, and it has taken this panel well over a year to resolve this case, we need not resort to speculation as to whether or not the rates established by the Commission might deny Pepco an opportunity of earning a fair rate of return as asserted by the company. We need only examine what the actual earnings were for the year 1976 under the new rates.

On March 1, 1977, the Commission, in Formal Case No. 666 issued order No. 5866 authorizing Pepco "to issue and sell up to 4,000,000 shares of its common stock, $10 par value . . . ." The order was based upon financial data supplied by the company in its application and supporting exhibits of which I can take notice[9] it being a formal record of the Public Service Commission consisting of data prepared and filed by the company itself (23 D.C. Register 7254).

Attached to the application filed on January 28, 1977, was the company's SEC form S-7 showing registration of the stock with the Securities & Exchange Commission. This exhibit reflected company annual net earnings of

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[9] *Washington Gas Light Co. v. Baker*, 90 U.S.App.D.C. 98, 104, 195 F.2d 29, 35 (1951); *Commonwealth v. United States Steel Corp.*, 10 Pa.Cmwlth. 408, 410, 311 A.2d 170, 172 (1973). This is not a taking of judicial notice of evidence that the hearing agency could have used in establishing a rate base or in deciding what a fair rate of return would be, but merely is the taking of a realistic, after the fact, view of the results of an allegedly confiscatory rate order.

$1.16 per share as of December 31, 1975, which improved to $1.72 per share as of December 31, 1976, an increase of nearly 50%.

The market price of the stock was shown to be:

4th quarter 1975	low 10	high 12 1/4
4th quarter 1976	low 13 1/2	high 14 7/8

According to company figures the last transaction on January 26, 1977, was at 15⅝.

When the instant case was argued before the Commission in September 1975, Pepco's counsel pointed out that the company's common stock had been traded the day before at only $10½. This means that in 16 months the stock increased approximately 50% in market value. Furthermore, according to these records, the company on January 21, 1977, raised its quarterly dividend from an annual rate of $1.16 per share to a rate of $1.28 per share.

In view of this self-proclaimed record of increased earnings, I would dispose of the majority's assertions here that the conclusions of the Commission were arbitrary and the rates it set were confiscatory by reminding it of the Supreme Court's admonition that:

> "Estimates for tomorrow cannot ignore prices of today." *Southwestern Bell Telephone Co.* v. *Public Service Commission of Missouri*, [262 U.S. 276, 288]. We have said of an attempt by a utility to give prophecy the first place and experience the second that "elaborate calculations which are at war with realities are of no avail." *Lindheimer* v. *Illinois Bell Telephone Co.*, 292 U.S. 151, 164. We say the same of a like attempt by officers of government prescribing rates to be effective in years when experience has spoken. A forecast gives us one rate. A survey gives an-

> other. To prefer the forecast to the survey is an arbitrary judgment. [*West Ohio Gas v. Public Utilities Commission*, *supra* at 82.]

In this remand, the majority has blinded itself to the fact that "experience has spoken" in direct contradiction to its doomsday forecast.

Commission records reflect that a year later it granted Pepco another and larger rate increase on December 16, 1976, of $29.4 million which should reflect even better results for the company in its 1977 earnings.[10] That case is presently pending in this court on an appeal taken by an intervenor.

VI. Remedy

After vacating this order, the majority states that it remands the case with directions to the Commission to "calculate modified rates . . . based upon data submitted for the test year ended June 1975, and then must calculate the revenue losses improperly experienced by Pepco during the period that order No. 5739 was in effect." I am at a loss to understand the majority's discussion of "losses" or how it expects them to be calculated. If the remand contemplates the company being authorized to charge higher rates in the future in order to recoup past losses (1975), it would be contrary to the law in this jurisdiction. *Payne v. Washington Metropolitan Area Transit Commission*, 134 U.S.App.D.C. 321, 333, 415 F.2d 901, 913 (1968).

Although the remand is something less than specific, one point comes through quite clearly, that is the majority is directing the Commission to accept all of the company's figures ending June 30, 1975, at face value despite the

[10] *See* order No. 5849, 22 D.C. Register 4147.

limited examination accorded them by the Commission staff and the fact that coming in late they were not the subject of counter testimony and comment by any of the staff or intervenors' witnesses. This seems to be the equivalent of ordering the Commission to accept the company's updated figures and based thereon to grant the company the full amount of increased revenues it requested of well over $20 million. I find this unprecedented and a wholly unwarranted assumption by this court of the functions of the regulatory body.

As to how far a reviewing court may go, the Supreme Court has said:

> More important, we have heretofore emphasized that Congress has entrusted the regulation of the natural gas industry to the informed judgment of the Commission, and not to the preferences of reviewing courts. A presumption of validity therefore attaches to each exercise of the Commission's expertise, and those who would overturn the Commission's judgment undertake "the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences." *FPC* v. *Hope Natural Gas Co., supra*, at 602. . . .
>
> Moreover, this Court has often acknowledged that the Commission is not required by the Constitution or the Natural Gas Act to adopt as just and reasonable any particular rate level; rather, courts are without authority to set aside any rate selected by the Commission which is within a "zone of reasonableness." *FPC* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 585. No other rule would be consonant with the broad responsibilities given to the Commission by Congress; it

> must be free, within the limitations imposed by pertinent constitutional and statutory commands, to devise methods of regulation capable of equitably reconciling diverse and conflicting interests. [*Permian Basin Area Rate Cases, supra* at 767.]

See also Federal Power Commission v. Transcontinental Gas Pipe Line, 423 U.S. 326, 331 (1976) (per curiam).

In *Telephone Users Association v. Public Service Commission, supra*, this court held that because the Commission failed to make adequate findings based on evidence in the record regarding the utility's claim of attrition, the case had to be remanded for *the Commission* to make those required findings. We specifically noted that:

> We are *not* today holding that C&P's evidence in the record require a finding by the Commission of attrition, or that if the Commission finds attrition it would be *compelled* to use C&P's year-end rather than its weighted average rate base. [*Id.* at 301 (footnote omitted) (emphasis in the original).]

Those words are overruled by today's decision. The majority's remand order in the instant appeal fails to recognize the critical distinction between telling the Commission where it erred and to reconsider its decision, and directing the Commission to arrive at new rates based on updated company figures some of which the Commission may not have found acceptable. This court's role ends when the error has been pointed out and the case remanded for the agency to apply its expertise in correcting the error. An appellate court cannot dictate the result the agency must reach.

"The court's responsibility is not to supplant the Commission's balance of these [factors] with one more nearly

to its liking, but instead to assure itself that the Commission has given reasoned consideration to each of the pertinent factors." *Permian Basin Area Rate Cases, supra* at 792.

The scope of the remand order here so far exceeds the power of this court that it goes a long way toward making us a superregulatory commission even though we are devoid of regulatory expertise.

The majority's act of directing the Commission to compute the new rates on specified company figures is done, no doubt, to avoid a rehearing by the Commission on remand, which at this late date would necessarily be a cumbersome and confusing administrative tangle. The Commission, on remand, would be compelled to use the June 30, 1975 figures even though on a later Pepco rate application in December 1975 it has already issued an order (in December 1976) granting another company rate increase based on all of calendar year 1975 including the identical data for the first six months of 1975 in issue here. By ordering the Commission to add substantially to the company's revenues with revised rates retroactively back to December 1975, the majority puts in serious question the validity of the later rate order of December 1976 which was based on a full 1975 test year. Since the company did not in fact experience a deficit in 1976, under the rates here in issue, but more than met its operating expenses for that year with a handsome net income left over, the added revenues of more than $20,000,000 from the surcharge ordered by the majority would constitute additional net profit for 1976. Will company customers petition for a revision downward of the December 1976 rate order in light of the very substantial revision upward in company earnings for 1976 resulting from this remand, and would the customers assert claims against

Pepco for the overcharges in 1977 resulting from the now erroneous December 1976 rate increase? Will today's new customers who are assessed this surcharge to make up the $20 million in revenues for 1976 claim an exemption as not having received any Pepco service that year?

The pending appeal of the December 1976 order will be proceeding on a record that is no longer valid unless remanded first for a further hearing and revision of the order. The surcharge levied here for 1976 could be followed by a rebate to customers for overpayments in 1977. When do rates become final and litigation come to an end?

In any event, it now appears that a remand would be useless. Although the majority has denied the Commission's motion to dismiss for mootness, the fact remains that the order appealed from, No. 5739, no longer is of any real force or effect having been superseded on December 16, 1976, by order No. 5849 under which the company is now operating. That order awarded the company a further increase designed to produce an additional $29.4 million in revenues. Consequently the company already has been awarded an increase of well over $5 million more than it seeks in this appeal. As a result if this case is to be remanded to the Commission it can afford Pepco no greater measure of relief than that already granted.

When a similar problem was faced by the Circuit upon its holding that an increase in gas rates was invalid, the court said:

> These matters having been disposed of by this opinion insofar as it is possible now to do so, very little will be left which could be remanded to the Commission, especially as any possible remaining issues are also restricted by a new application of the Company to the Commission for a rate in-

> crease, filed since argument of these appeals, and of which we take judicial notice. Remand to the Commission, in the circumstances of this case, could not be to enable a rate order to be superimposed upon the old application, filed July 14, 1949. [*Washington Gas Light Co. v. Baker*, 90 U.S.App.D.C. 98, 104, 195 F.2d 29, 35 (1951).]

It is difficult to perceive how the Commission could grant further affirmative relief on the application for an increase in revenues at issue in this appeal.

I submit that the reversal here is not only wholly unjustified, but it creates an administrative nightmare. For all of the foregoing reasons, I dissent. I would dismiss the appeal and affirm the order of the Commission.

APPENDIX

Order No. 5739

The next issue we must address under the heading of rate base is the perennial question of whether to use average or end of period figures. There is not, and indeed there cannot be, any question on this record that PEPCO has experienced a decline in earnings in the latter half of 1974 and that this declining trend shows no signs of a reversal. This fact, of course, does not in and of itself demonstrate the presence of "*attrition.*" As the Commission said in the last PEPCO rate case "while a decline in rate of return may be the result of attrition, it may with equal validity be said to result from other factors, *e.g.*, imprudent investment or excessive expenses."

As we have indicated in our preliminary views, it appears to us that the major factors contributing to PEPCO's decline in earnings were the reduction in kilowatt sales to retail customers and the significant drop in sales to PJM. Putting these two factors aside, however, the record is clear that the increase in investment costs per unit of output noted in our last decision has continued; and in this case not only is this fact demonstrated by the actual dollar investment figures in the record but it is confirmed, we believe, by the vigorous advocacy on the part of consumer intervenors of the use of marginal or long run incremental cost figures for rate making purposes. The underlying theory of this advocacy is that the cost of new production plant is higher than the average embedded cost of that plant. Thus, while we are urged by some parties to match revenue, expense and rate base by using average rate base figures, we find little support in the record for those recommendations. In short, we are persuaded that attrition is a phenomenon that is still with us, and we will

therefore now, as we have in the past, use an end of period rate base, with appropriate adjustments, in order to compensate for the presence of attrition.

The point is made by PEPCO that use of an end of period rate base will only partially reflect the "attrition" in earnings that has taken place since our 1973 PEPCO decision. We are not persuaded, however, that the decline in earnings has been due solely to attrition, but has in large part been due to the drop in sales noted previously. Since sales to retail customers appear to have resumed a somewhat normal growth pattern, and since sales to PJM appear to have leveled off to a large degree, and since PEPCO has substantially reduced its construction budget it appears reasonable to conclude that attrition in the future may play a less significant role than it has in the past.

A number of adjustments to rate base have been presented for consideration by our Staff and by several of the intervening parties in this case. People's Counsel witness McCabe, for example, with the support of other consumer parties, has urged elimination of construction work in progress from the rate base and substitution of an allowance for funds used during construction (AFUDC). Our Chief Accountant, Mr. Manheimer, noting the unusually large amounts included in construction work in progress at year end, has recommended averaging construction work in progress over the test period. Intervenor All Souls Unitarian Church has urged that PEPCO's investment in the Douglas Point Nuclear station be eliminated from rate base. Mr. Manheimer also recommends that we average materials and supplies over the test period, and that we eliminate amounts reflecting preliminary surveys, land transactions undistributed, prepaid insurance, and compensating bank balances, in our calculation of rate base.

We have given most serious consideration to all of these recommendations. We are disposed to agree with our Staff and accept Mr. Manheimer's recommendation for the use of an average amount of construction work in progress and an average amount in the materials and supplies account in rate base as more representative of the flow of dollars in and out of the accounts. The record shows wide fluctuations in these accounts over time and a substantial increase in fuel inventories in 1974, resulting from stockpiling due to the unusual fuel market in that year. The amounts at the end of the period in both accounts appear to be abnormally high. In view of PEPCO's projected reduction in its construction program and the reduction in fuel inventory in 1975, we do not believe that the end period figures can be called representative of anticipated future conditions. The adjustment of materials and supplies is consistent with the Commission's treatment accorded to this item in Formal Case No. 610.

With regard to Mr. McCabe's recommendation that construction work in progress be excluded from rate base (a recommendation subsequently modified to permit 10% of plant in service to be included as a construction work in progress allowance) we are disturbed by two factors. First, the 10% allowance appears to us to be wholly arbitrary and without foundation. Second, we would note that including CWIP in rate base without AFUDC and capitalizing AFUDC but excluding CWIP from rate base produce about the same ultimate result. Essentially, only the timing is different; but in the long run, use of AFUDC may result in a greater overall cost to the customer than inclusion in the rate base of construction work in progress. Projects begun in the period between rate cases, for example, earn no return under the CWIP approach, and if placed in service prior to the next rate

case appear in rate base at the actual cost of the project. Were AFUDC used, the same project would appear in rate base at the cost of the project plus capitalized interest, and ratepayers would be required to provide a return on that higher cost. In consideration of all factors, we believe that the interest of both customer and investor would be better served by continuing our long standing practice of allowing PEPCO to include construction work in progress in its rate base.

With regard to the Douglas Point nuclear project, there is no question but that substantial funds have been invested in that project, and that nuclear projects require an extraordinarily long lead time required to plan and complete. We understand and appreciate the views expressed by All Souls witness Father Millard in support of his recommendation that the $28.6 million already invested in Douglas Point now be excluded from rate base. In consideration of current fuel uncertainties and the 8 year or longer lead time, however, we are not convinced that we should at this time declare the nuclear project imprudent or unnecessary.

We are disposed to agree with our Chief Accountant that amounts reflecting preliminary surveys and undistributed land transactions should not be included in rate base. As Mr. Manheimer has pointed out, there is no certainty that any of these amounts will be transferred to plant in service and for that reason we believe their exclusion is appropriate. Similarly, we agree with Mr. Manheimer that prepaid insurance premiums and compensation bank balances should be excluded from rate base, since insurance premiums are expensed over time and compensating bank balances are in our view more properly a part of the cost of money and have been included in our calculations of fair rate of return.

For these reasons, then, and having considered all data and recommendations of record, we find the appropriate District of Columbia rate base to be $650,091,000, as shown on Attachment A, Page 1.

To achieve a 9.1% rate of return on a rate base of $650,091,000, PEPCO's operations must produce a return of $59,158,000, as shown on Attachment A, Page 3. We turn now to consideration of observed expenses and operating results, from which we may determine the amount of revenues needed to produce this net return.

NEBEKER, *Associate Judge*, concurring: In view of both the content and tone of my Brother's dissent, I feel constrained to elaborate upon my joining in the majority opinion. I am convinced that the majority opinion is wholly legally valid and manifests a realistic (and dispassionate) assessment of the issues in this case. Moreover, its conclusions are mandated by precedent as well as by common sense.

Both the majority and dissenting opinions recognize certain of the basic principles related to the scope of our review over the Commission's decisions; a few of the many decisions relied upon by the majority also are cited in the dissent. Where our dissenter goes astray, in my view, is in his apparent belief that if agency action is "considered," it is immunized against a finding of arbitrariness or capriciousness. The dissent would simply accept at face value the Commission's broad conclusions as individually reached, and would avoid further inquiry into the correctness of the supporting evidence, as well as into the conflicts, the omissions, and the practical effect of the opinion as a whole. The majority opinion,

however, goes the inescapably necessary step beyond the dissent in making those inquiries.

I. Assertions of Error

In disputing the majority's determination that the Commission's opinion was arbitrary and capricious, the dissent begins by characterizing the majority opinion as being wholly "unsupported and unjustified." Yet the majority opinion is replete with supporting evidence, and its analysis of the law as applied to the facts is in accordance with controlling precedent.

The dissent declares:

> An examination of each of the Commission's findings and conclusions reveals that none was arrived at arbitrarily, but rather only after thoughtful consideration of the evidence and of the arguments on each side.

Thoughtful consideration, however, does not preclude the ensuing results from being arrived at arbitrarily. The Commission undoubtedly did give thoughtful consideration to the issues raised, but still it reached a legally invalid conclusion. That it did by ignoring significant data submitted through June of 1975.

The dissent also attacks as "pure speculation" the majority's conclusion that the relatively small increase in revenues granted by the Commission would not allow the company an opportunity to earn a fair rate of return, to maintain its financial integrity, and to attract capital, as required by *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 605 (1944). Yet the record contains abundant, clear, and uncontroverted evidence (1) of Pepco's rapidly declining financial position,[1] (2) that the

[1] *See* pages 12-17 of the majority opinion.

practical effect of this position was to preclude the company from attracting capital and maintaining investor confidence,[2] (3) that the data submitted for the first half of 1975 showed convincingly that the steep decline in rate of return on equity had rendered useless the corresponding 1974 test year figures used by the Commission,[3] and (4) that the measures previously adopted by the Commission to combat the attrition in Pepco's earnings had proved inadequate in times of lesser inflation.[4] A conclusion by a reviewing court which is based on such extensive record evidence cannot be purely speculative, and an agency order which effectively ignores or improperly rationalizes away such concrete and convincing evidence cannot be allowed to stand. Pepco thus met its "heavy burden" of showing severe and unconstitutional prejudice resulting from the Commission's orders.

II. The Standard of Review

Contrary to the dissent's assertion, the majority opinion carefully adheres to the standards set by Congress, as well as by the Supreme Court and our own precedents. The majority first considered the overall effect of the Commission's opinion, as it was bound to do under *Federal Power Commission v. Hope Natural Gas Co.*, *supra* at 602, *The Permian Basin Area Rate Cases*, 390 U.S. 747, 791 (1968), and our own *Telephone Users Association v. Public Service Commission*, D.C.App., 304 A.2d 293, 297 (1973). Having concluded that the effect of the Commission's action was unjust and unreasonable, in that it would not allow Pepco a reasonable opportunity to earn

[2] *See id.* at 15-16.

[3] *See id.* at 18-19.

[4] *See id.* at 23 and 38-39.

its authorized rate of return and maintain its financial integrity, the majority proceeded to give reasoned consideration to the contested elements of the opinion, a practice established by the Supreme Court and followed by this court in the *Telephone Users* case, *supra* at 298. Finding then that several of the Commission's conclusions were arbitrary because they *in effect* ignored volumes of the most recent uncontested data of record, we vacate and remand the decision with instructions, as authorized by D.C. Code 1973, § 43-705. Legal errors and omissions such as these cannot be shielded from even the narrowest appellate review merely because the Commission made several conclusory statements supported by insufficient, contradictory, misleading or erroneous evidence, regarding its full consideration of the issues. Such transgressions are in direct contradiction to controlling precedent and logic.

To bolster its argument, the dissent posits that "the Commission did not pick its conclusions out of thin air." Surely, however, the bounds of judicial review are not set by this novel "thin-air" standard. As noted, the Commission may reach its conclusions in a manner which is thoughtful but nevertheless arbitrary. To hold otherwise would be to render any appellate review a meaningless formality.

Finally, the dissent suggests that the Commission's inclusion of some updated figures in its "reckoning" removes its opinion from the zone of arbitrariness defined in *West Ohio Gas Co. v. Public Utilities Commission*, 294 U.S. 79 (1935). However, the Commission's exclusion of the most crucial parts of the updated data, as discussed by the majority, was as arbitrary as the action condemned in *West Ohio Gas*. The Commission's selective use of certain updated figures, therefore, does not insulate its action from our review.

The flaws in the Commission's opinion and orders, accordingly, may not be shelved as being reflective of "a difference in judgment," as the dissent would have us do. We may not hold that the Commission's conclusory statements regarding its consideration of the issues, statements which did not take into account crucial and substantial data of record, preclude our finding arbitrary and capricious action in this case. I now address in turn the specific assertions of error contested by the dissent.

III. The Test Year

As regards the proper test year, once again the dissent is unwilling to analyze the evidence beyond its superficial presentation by the Commission's majority opinion. In defense of the Commission's use of calendar 1974 as the test year, the dissent argues primarily that Pepco did not exhibit an unequivocal intent to have the new data, which were presented in a format identical to that of the calendar 1974 data, and duly received into evidence, substituted for it. As this subject is thoroughly discussed in the majority opinion,[5] here I shall mention only the fact that the dissent relies upon the expressed condition accompanying Pepco's request to substitute updated data to eradicate the existence of the request. The majority's more thorough examination of the issue reveals that the condition—*i.e.*, Pepco's insistence that it could not afford a reopening of the hearings—was added out of an abundance of caution on Pepco's part, and was not legally a prerequisite to the Commission's ultimate determination of the issue.[6] Public hearings are held primarily to assist

[5] *See* section IV thereof.

[6] The majority reasoned that as the new submission followed the same format as the original, and as the purpose of the proceedings—to determine the relationships among reve-

the Commission's determination of the proper *relationships* among components of new rates; the actual figures for those components must only be verified by simple audit to meet the requirements of due process and fairness. The dissent cites no authority to the contrary. The Commission did not have to reopen the hearings, and in fact it did not. Hence the significance of Pepco's caveat evaporated.

Moreover, I note that the Commission—like the Federal Power Commission and state public service commissions—routinely accepts and incorporates into its opinions new data submitted late in rate proceedings for the purpose of updating the old data, allowing only a short time for an audit of the new figures. *See, e.g., City of New York v. New York Public Service Commission*, 42 App.Div.2d 259, 346 N.Y.S.2d 6 (1973). As there is no cognizable reason for its refusal to do so in this case, I can only conclude that the Commission erred.[7]

The dissent also is in error when it states: "In oral argument to the Commission Pepco did not raise any question about a June 30, 1975, test year." To support

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nue/expense/rate base components—had already been fulfilled and could not have been advanced by new hearings, considerations of fairness and due process would not have required such a reopening of the record. The dissent's suggestion to the contrary is unsupported and erroneous.

[7] The argument forwarded by the Commission that "the proceedings must end at some point" is unpersuasive in this context. The new data were submitted five months prior to the issuance of the Commission's opinion, and before the close of the hearings. Moreover, they constituted the most recent available data, which, among other precedents, *West Ohio Gas Co. v. Public Utilities Comm'n, supra,* at 82, and *Telephone Users Ass'n v. Public Comm'n, supra* at 297, requires to be given serious consideration. Here they were effectively ignored.

this statement, the dissent quotes as follows from the argument of Pepco's counsel:

> Now what solutions to the attrition problem exist?
>
> The one that's traditionally been used by this Commission and most others is year-end rate base, and we think that if the Commission is going to stick with the 1974 test period that that's a minimum. . . . [Tr. 2821-22]

While I believe that counsel's use of "if" cuts against the dissent's contention (particularly when it is recognized that the Commission ultimately used average, rather than year-end figures for Construction Work in Progress and Materials and Supplies), the part of counsel's argument which immediately followed is dispositive of that contention:

> . . . and that minimum . . . is not enough. . . .
> Now, there are other things you could do.
> One of them is to recognize the need for updating [the] test period.

The result reached in the majority opinion on the question of updating the test period is valid and conforms to the long line of Supreme Court cases and our own precedent which require that a rate maker consider, and make appropriate adjustments for, the most recent data of record.[8] Therefore, as Pepco's operating results and financial

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[8] The case of *Arkansas Power & Light Co. v. Arkansas Pub. Serv. Comm'n*, 289 S.W.2d 668 (Ark. 1956), cited by the dissent on this subject, is factually distinguishable from the instant case. In *Arkansas*, the utility filed its application for new rates on May 27, 1954, and based its request on a test year ended March 31, 1954. After extensive hearings were held, the Commission issued its order on November 22 of the

condition underwent drastic changes after the end of the originally-submitted test year, and as the delay occasioned by the administrative process was quite long, the only appropriate consideration of the data for the first half of 1975 must involve their use in a test period.

IV. Attrition and Use of 1975 Data

In contesting the majority's treatment of attrition, the dissent once again mistakes the Commission's simple acknowledgment that "attrition . . . is still with us" for a legally valid effort to solve the problem. As support for its statement, the Commission added:

> [W]e will therefore now, as we have in the past use an end of period rate base, with appropriate adjustments, in order to compensate for the presence of attrition.

The inevitable effect, however, of the "adjustments" made (*i.e.*, the use of weighted average, rather than year-end figures for two of the three major rate base components) was the creation of a revenue deficiency which more than offset the small attrition allowance resulting from the use

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same year. Although the company at some point requested that the Commission consider the period from March 31 to August 31, 1954, as an additional testing period, there appeared to be no specific reason or real need for this request. Unlike in the instant case, no assertions of a significant financial change in the company's status were made, and the length of time taken up by administrative delay was short. Moreover, the mid-1950's did not witness the inflation and fuel cost increases to which today's utilities are being subjected. Far more to the point, for example, is *New York Telephone Co. v. Public Serv. Comm'n*, 29 N.Y.2d 164, 342 N.Y.S. 53 (1971), in which the New York Court of Appeals readily reversed that state's Commission's refusal to give proper effect to the utility's most recent historical operating data.

of a period-end figure for the third component. (This fact is not mentioned in the dissent.) Moreover, the predictive value of setting rate figures which may have been reasonable during the test year, without considering more recent data which differ significantly from those presented for the test year, is negligible. It was for this reason that the Supreme Court so clearly proscribed the use of outdated data in *West Ohio Gas Co. v. Public Utilities Commission*, *supra* at 82, and its holding controls the resolution of the test year issue in the instant case.

In the Commission's ruling on Pepco's petition for reconsideration, it again paid lip service to the existence of Pepco's continuing financial decline, and added:

> This fact was fully considered by the Commission in arriving at its decision in this case, even though the decision was indeed based on a 1974 calendar year test period.

Yet the Commission proceeded to offer two weak and unsupported reasons for its failure to grant the relief requested. As regards the first reason, there was no basis in the record or in logic for the Commission to assume that Pepco did not request that operating data for the year ended June 30, 1975, be used. Secondly, while asserting that it was not persuaded that Pepco's financial decline in 1975 could be attributed to "attrition", the Commission gave no reason for reaching this conclusion, and did not state why such a decline should not be adjusted for in some way even if it were not related to attrition. Such a conclusion could not be labeled anything other than arbitrary and capricious. It is difficult to fathom how our dissenting Brother apparently can believe that the Commission's reasoning carries "considerable logic," thereby defeating "any contention that the decision as to CWIP was arbitrary."

Concerning the Commission's misuse (by substantial nonuse) of the most recent available data, I would only refer the reader to the majority's discussion of the June 30, 1975, data, attrition, and the rate base components, and repeat that superficial assertions concerning the Commission's "thoughtful consideration" of the 1975 data, when not followed by remedial action, may not successfully disguise what otherwise are readily recognizable as unreasonable, arbitrary, or capricious rulings. This is particularly true when the subject of attrition is discussed, as, regardless of how the Commission rationalized away its existence, any knowledgeable person could perceive that there remained on the record uncontradicted evidence of continuing and exacerbated attrition through the first half of 1975.

V. 1976 Operating Results

Perhaps the most alarming aspect of the dissent, however, is its unfettered use of extra-record material as supposedly providing major support for its position. It refers to stock prices and to a Securities and Exchange Commission filing by Pepco as evidence that, with the contested rates in effect, Pepco was able to make financial progress. This use of such extra-record material is not only proscribed by controlling case law and by the relevant statute, but also is dangerously incomplete in its analysis and suggests erroneously that this court's decisional judgments routinely are affected by extra-record "facts."

As long ago as 1813, the Supreme Court held that facts which do not appear in the record cannot be noticed by a reviewing court, even if those facts would be sufficient to change the outcome of the case. *Thornton v. Carson*, 11 U.S. (7 Cranch) 596, 601 (1813). The dissent's gambol

beyond the confines of the record also is prohibited by statute. D.C. Code 1973, § 43-705 provides in part that: "Any such appeal shall be heard upon the record on appeal, and no new or additional evidence shall be received by [this] court." As appeal can be taken only from the order as issued by the Commission, we may not consider evidence which was not available to the Commission at the time of issuance. Moreover, the extra-record materials do not contain facts of common knowledge, nor are they capable of such certain verification that they may be judicially noticed. *Massachusetts v. Westcott*, —— U.S. ——, 52 L.Ed.2d 349, 97 S.Ct. 1755 (1977).

The dissent's selective use of material unavailable to Pepco during the proceeding (since it did not exist), or to the Commission in formulating its opinion, also makes no practical sense. The materials cited in no way constitute a meaningful treatment of the subject, they are not inherently reliable, and their contents may have no meaningful relationship to the rates contemporaneously in effect.[9] The dissent's reliance upon extra-record material is as erroneous as it is curious when one considers the dissent's position on the test year issue: our Brother sanctions the Commission's effective disregard of the most current and compelling evidence of record, but relies heavily himself on "information" which did not even exist until some two years after the record which we review was closed.

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[9] The increase in earnings may be attributable to the unusual weather conditions discussed in the majority opinion, to a trend in stock investment patterns, to increases in rates which Pepco may charge its many non-District of Columbia customers (of which we have no record knowledge), or to any number of other factors. Additionally, we have no knowledge as to what has happened to Pepco's expenses and rate base in the two years since the record before us was closed.

VI. Remedy

Finally, the dissent's discussion of the remedy prescribed rests upon two misconceptions. The first is that the majority directed specific dollar results in its remand order. In fact, the majority mandated the Commission only to recalculate the rate base and revenue requirements using the actual and audited data of record for the test year ended June 30, 1975. This certainly was not done, as the dissent accuses, "to avoid a hearing by the Commission on remand," but necessarily to conform to legal standards.

Secondly, the dissent contests our authority to outline the remedies on remand.[10] Yet the majority opinion conforms to the procedures mandated by D.C. Code 1973, § 43-705.[11] It has accompanied its vacating of the Commission's order with detailed reasons for its action, and has related "the particulars in and the extent to which such order or decision was defective." It has not assumed the administrative function of setting rates, and, after correcting the Commission's legal errors, has left the actual establishment of just rates to the Commission. Moreover, it has tempered its decision with equitable considerations to assure fair treatment to the consumer, as well as the investor. The dissent does not address this aspect of our decision. One must remember that the true interests

[10] The dissent also states its belief—which the majority does not share—that the validity of the rate increase granted subsequent to the one here is placed "in serious question." Any further review of that decision would be occasioned only by action of the parties, and not of necessity.

[11] Contrary to the dissent's claim, the *Telephone Users* case does not set the parameters of this court's authority. The quoted language specifies only what this court did not do—it by no means indicated what we *could* not do in any given situation.

of the consumers do not rest solely on artificially low utility rates. In the ultimate analysis, the consumer cannot and will not afford the inadequate utility services which inevitably would follow as a consequence of short-term, confiscatory rates. I remain convinced that the reasoning of the majority opinion is not only wholly sound but also is in the best interests of the public.[12]

[12] Warranting quotation is the following paragraph from Commissioner Stratton's dissenting opinion:

> To sum up, the commission's order posits an economic environment reminiscent of the early 1960's. In failing to acknowledge and deal with the fact that operating and capital requirements per unit of sales have risen, and continue to rise, faster than revenues the commission has taken a step that can only bring regulation in the District of Columbia into disrepute among the fair-minded and knowledgeable.

APPENDIX D

DISTRICT OF COLUMBIA COURT OF APPEALS

No. 10490

POTOMAC ELECTRIC POWER COMPANY, PETITIONER,

v.

THE PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA, RESPONDENT,

PEOPLE'S COUNSEL, INTERVENOR.

Petition of Appeal of Orders of the Public Service Commission of the District of Columbia

(Argued en banc May 5, 1978 Decided May 1, 1979)

Carl D. Hobelman, of the bar of the State of New York, *pro hac vice*, by special leave of court, with whom *Alan G. Kirk II* and *Lawrence A. Gollomp* were on the answer to petitions for rehearing or, in the alternative, rehearing en banc, for petitioner.

John R. Risher, Jr., Corporation Counsel at the time the case was argued, with whom *Richard W. Barton*, Deputy Corporation Counsel, and *James T. McManus*, Assistant Corporation Counsel, were on the petition for rehearing or rehearing en banc, for respondent.

Brian Lederer, with whom *Elizabeth Noel* was on the petition for rehearing or, in the alternative, for rehearing en banc, for intervenor.

Before NEWMAN, *Chief Judge*, and KELLY, KERN, GALLAGHER, NEBEKER, YEAGLEY, HARRIS, MACK and FERREN, *Associate Judges*.

Opinion for the court by *Associate Judge* YEAGLEY.

Dissenting opinion by *Associate Judge* HARRIS at p. 29, with whom Judge Nebeker concurs.

YEAGLEY, *Associate Judge*: Potomac Electric Power Company hereinafter Pepco or the Company), petitioned this court, pursuant to D.C. Code 1973, §43-705, to re view two orders of respondent Public Service Commission of the District of Columbia (hereinafter PSC or the Commission); first, Order No. 5739 of November 19, 1975,* granted Pepco an increase in retail rates of $27,657,000 based on the request of the Company, as amended, for an increase in revenues of $50,832,000; the second, Order No. 5750 of January 12, 1976, denied Pepco's petition for reconsideration. On November 9, 1977, a division of the court, with this judge dissenting, held that the increase in revenues authorized by the PSC was so deficient as to be confiscatory and therefore unreasonable, arbitrary and capricious within the meaning of D.C. Code 1973, § 43-706. The orders of the PSC were vacated and the case remanded with instructions to the Commission to base the new rates on Company data for a test year ending June 30, 1975, rather than on a 1974 test year as originally suggested by Pepco and as found to be proper by the Commission, and to revise the rates upward accordingly.[1] It also instructed the Commission

* The Commission's order is reported in 11 P.U.R. 4th 215 (PSC D.C. 1975).

[1] *Potomac Electric Power Co. v. Public Service Commission*, D.C.App., 380 A.2d 126 (1977).

to "calculate the revenue losses improperly experienced by Pepco during the period that Order No. 5739 was in effect." By ordering the Commission to accept the 1975 data and to base the new rates thereon, the court deprived the Commission of its right to examine and test the new data at a public hearing and left the Commission little room in which to exercise its discretion to consider the justification, if any, for determining that Pepco revenues should be increased by approximately $50,832,000 instead of the $27,657,000 it had previously authorized. The court order also deprived the PSC of any reasonable opportunity to balance the interests of the consumer. After reargument en banc, we now hold, with the former majority dissenting, that there was no reversible error in the orders of the PSC, and affirm the two orders of the Commission.

PROCEDURAL HISTORY

The procedural history of this case is long and involved. On December 20, 1974, Pepco filed an application with the Commission based on a 1974 test year seeking an increase in rates for the sale of electrical energy so as to produce an increase in operating revenues of approximately $48,000,000. Later as more recent 1974 figures became available, it increased its request to $50,832,000. Following a series of postponements and delays,[2] the Commission issued Order No. 5718 on May 20,

[2] During the pendency of its basic application, Pepco twice sought interim rate increases by applications dated March 12, 1975, and July 3, 1975. Each application was dismissed by the Commission, the first in Order No. 5707, dated April 7, 1975, and the second in Order No. 5725, dated July 11, 1975. Since no appeal was taken from these orders, and as they are not directly challenged here, we have no jurisdiction to modify them. However, they necessarily constitute a part of the history of the Company's appeal to the Commission for relief.

1975, granting *inter alia* intervention to 13 parties, one of whom, People's Counsel, is an intervenor on appeal here.[3] The hearings were held from June 4 through July 24, 1975. On July 18, Pepco filed with its rebuttal testimony new data reflecting its operations from January 1 through June 30, 1975. After comparatively brief cross-examination on that data, and no surrebuttal, oral argument was heard by the Commission on the merits of the application and on November 12, 1975, it issued its order finding a 9.1% rate of return would be reasonable and authorizing an increase in the Company's operating revenues in the District of Columbia for the year of $27,657,000, so as to provide an increase in net income of $12,302,000. A dissenting opinion by Commissioner Stratton called for a substantially higher rate base. On December 12, 1975, the Commission approved the new schedule of rates filed by Pepco in accordance with the foregoing order which became effective the following day. A motion for reconsideration was denied on January 12, 1976, and Pepco appealed.

The Commission's action in Order No. 5739 was its fourth decision in six years on applications for rate increases by Pepco. Apparently the reason for filing this request so soon after a 1973 increase was the steady decline in Pepco's financial condition in the last half of 1974. The Commission saw two factors as the principal causes of this decline: (1) energy conservation by consumers as urged upon them by the government, interested private organizations and Pepco itself because of the

[3] The office of the People's Counsel was established by Congress on January 2, 1975. *See* D.C. Code 1975 Supp., § 43-205. Part of the initial delay in this case was occasioned by the desire of the Commission, quite properly, to obtain the views of the People's Counsel, although there was a time lag in establishing that office.

national energy crisis experience that year which resulted in a substantial decrease in the number of kilowatt hours sold at retail by Pepco; and (2) a substantial decrease in the "energy and capacity" sold by Pepco to the Pennsylvania, New Jersey, Maryland (PJM) Interchange Pool, of which Pepco is a member. The Commission found that had these two dramatic changes not occurred, "the need for a rate increase application by PEPCO may very well have been eliminated." Nevertheless, the Commission did not foresee a return to "past normalcy" of the pre-1974 years and thus found it necessary to pursue the lengthy process of adjusting electrical rates to accommodate those two factors and other changed conditions affecting Company operations.

Order No. 5739, which authorized new rates effective December 13, 1975, expired on December 16, 1976, when a new PSC order (No. 5849) authorized an additional $29.4 million in revenues based on another Pepco application filed in December 1975. Those new rates under which the Company now operates were set pursuant to another ratemaking proceeding which followed close on the heels of the instant case.

Assertions of Error

The errors advanced by the Company regarding the order appealed from were summarized by the division as follows:

> Examination of the elements of the opinion reveals several findings and conclusions (expressed in the Commission's opinion in an overlapping, narrative style) which are unreasonable, arbitrary, or capricious. These include the Commission's refusal to utilize the most recent test period in the record, its failure to account for continuing attrition, and its refusal to recognize

> certain known changes which occurred after the originally proposed calendar 1974 test period. [*Potomac Electric Power Co. v. Public Service Commission*, D.C.App., 380 A.2d 126, 132-33 (1977).]

The division held that even though the test year on which the Company based its application was calendar year 1974, it was arbitrary and capricious, and therefore error, for the Commission not to have used as the test year the Company figures revised as of year-end June 30, 1975. The division also concluded that the rates set would deny the Company an opportunity to earn a fair rate of return.

Scope of Review

In approaching petitioner's basic objections we note that the scope of our review of the Commission's final rate order is quite limited. D.C. Code 1973, § 43-706 provides that:

> In the determination of any appeal from an order or decision of the Commission the review by the court shall be limited to questions of law, including constitutional questions; and the findings of fact by the Commission shall be conclusive unless it shall appear that such findings of the Commission are unreasonable, arbitrary, or capricious.

By this provision Congress vested sole ratemaking authority in the PSC. We are not to substitute our judgment for that of the Commission. Even though we might arrive at a somewhat different decision than did the PSC, if there is substantial evidence to support the Commission's findings and conclusions, we must affirm. *See Williams v. Washington Metropolitan Area Transit Com-*

mission, 134 U.S.App.D.C. 342, 415 F.2d 922 (1968); *Watergate Improvement Associates v. Public Service Commission*, D.C.App., 326 A.2d 778, 783-84 (1974).

The power to make rates was clearly delegated by Congress to the Commission, not to this court. Our review of a utility commission order is the narrowest judicial review in the field of administrative law. K. Davis, Administrative Law of the Seventies § 29.00, at 647 (June 1976); 2 F. Cooper, State Administrative Law 756-72 (1965).

We have held that "the scope of our review of the Commission's actions is 'limited to questions of law . . . and the findings of fact by the Commission shall be conclusive unless it shall appear that such findings of the Commission are unreasonable, arbitrary or capricious.'" *Watergate Improvement Associates v. Public Service Commission*, *supra* at 783, *quoting* D.C. Code 1973, § 43-706. In an appeal by an intervenor of an earlier Pepco rate increase, Judge Harris, speaking for this court, said:

> Arbitrary action, however, is action not based on facts or reason. . . . The burden upon petitioner is not merely to put forth an acceptable alternative but rather to demonstrate clearly and convincingly a fatal flaw in the action taken. . . . Petitioner has not met that burden. He simply asserts a difference of opinion with the Commission. [*Goodman v. Public Service Commission*, D.C.App., 309 A.2d 97, 101 (1973) (citations omitted).]

Four years ago when some intervenors contested a $12,000,000 rate increase granted the company, this court in resolving the dispute quoted with approval the guiding rule for appellate review of utility agency orders as set

forth in *Williams v. Washington Metropolitan Area Transit Commission*, *supra* at 362, 415 F.2d at 942:

> Our role as a reviewing court is not to make an independent determination as to whether fares fixed by the Commission are just and reasonable, but rather to insure that the Commission, in exercising its rate-making power, has acted rationally and lawfully. Our function is normally exhausted when we have determined that the Commission has respected procedural requirements, has made findings based on substantial evidence, and has applied the correct legal standards to its substantive deliberations. [*Telephone Users Association v. Public Service Commission*, D.C.App., 304 A.2d 293, 296 (1973), *cert. denied*, 415 U.S. 933 (1974).]

"The court's responsibility is not to supplant the Commission's [balancing] of the [factors involved] with one more nearly to its liking, but instead to assure itself that the Commission has given reasoned consideration to each of the pertinent factors." *Permian Basin Area Rate Cases*, 390 U.S. 747, 792 (1968).

As long as there is substantial evidence to support a reasoned conclusion of the Commission we must affirm. *Watergate Improvement Associates v. Public Service Commission*, *supra* at 783-84. *See also Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 415 (1971). We review the proceedings and order of the Commission with those guidelines in mind.

The Test Year

Ratemaking for a particular utility is, in essence, the making of a forecast of its future financial condition upon the basis of its known performance during a span

of time in the immediate past, *viz.*, a "test period." *Telephone Users Association v. Public Service Commission*, *supra* at 297; *Michigan Wisconsin Pipe Line Co. v. Federal Power Commission*, 263 F.2d 553, 555-56 (6th Cir. 1959). Pepco argues on appeal that since the PSC did not use an amended test year period ending June 30, 1975, in determining its new rates, Pepco will be prevented from realizing an equitable rate of return on its investment.

In that regard we have admonished the Commission in *Telephone Users Association v. Public Service Commission*, *supra*, wherein the Commission failed to take into consideration the most recent data submitted by the utility, that the most recent available material must be considered and weighed by the Commission in reaching decisions on ratemaking. This is consistent with effective ratemaking policy. If recent operating figures are completely ignored, the new rate will be based on old and perhaps no longer valid data.

The problem becomes more acute when there is a long regulatory lag, as in the instant case where considerable time elapsed between the original request and the final decision. Although this is an inevitable part of the regulatory process where the rights of the company to rate relief must be balanced against the interests of the consumer in a hearing involving a myriad of parties, it is nonetheless important, in fairness to all, that the latest available operating data not be ignored. However, a request to use more recent data submitted in a last minute filing does not present the same situation and is not necessarily a fair or reasonable request. It is to be resolved in the reasonable exercise of the Commission's discretion.[4] We will not reverse and remand the decision

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[4] *See Vermont Yankee Nuclear Power Corp. v. Natural Resources Council, Inc.*, 98 S. Ct. 1197, 1217 n.22 (1978).

here for further hearings and consideration of the more recent data filed under these circumstances. First of all, as will be demonstrated by the record, Pepco did not make clear for any reasonable person to understand at the time it filed the new data that it was taking a position that the PSC must adopt a revised test year. Secondly, the Commission in using a 1974 test year did give weight and consideration to the 1975 data filed by Pepco. We would observe that filing the latest available operating data does not necessarily mandate a change in the test year by the Commission. Rather it should select a test year that appears likely to be representative of the future. *See generally, Interstate Commerce Commission v. City of Jersey City*, 322 U.S. 503, 515 (1944).

In the application for a rate increase filed by the Company, it asked that it be based on a 1974 calendar test year and it supplied figures for the first eight months of 1974 augmented with detailed estimates for the remaining four months. As figures for the Company's actual operations for those four months became available they were supplied by the Company. After cross-examination of Company witnesses was completed and as the respondent and intervenors were completing their testimony in opposition, the Company, on Friday, July 18, 1975, filed proposed rebuttal testimony of its Sr. Vice-Pres.-Finance, with two detailed exhibits which included financial data reflecting for the first time operating results from January 1 through June 30, 1975. (Company Exhibits G and 14.) The witness appeared and testified orally on those figures "in rebuttal" on Wednesday, July 23.

During cross-examination of that witness by counsel for the Commission, the following developed:

> Q. Mr. Davis, are you proposing a new test year for the Commission to use in this case?

> A. I have indicated in the testimony that we think it is important to place this information on a test year revenue requirement basis before the Commission. *Now we are not—not suggesting a substitution of the June 30 year for the December 31 year,* but I do ask, or do suggest in my rebuttal testimony, and I would ask, that the Commission take note of this information and apply it in reaching the conclusions in this case . . . . [Emphasis supplied.]

The Company relies principally on the testimony of Pepco's President, J. Reid Thompson, who in testifying in rebuttal that same day said: "I would urge the Commission to base its results on the June 30 figures."

However, when Mr. Thompson was cross-examined by People's Counsel, he made an important modification to that position in the following exchange:

> Q. . . . You are not suggesting a new period, are you? You still want your end of period rate base considered in this case December, 1974. You are not requesting an amendment of that at this time?
>
> A. I don't want to get bogged down in semantics or play a game.
>
> Q. Well, let's not get bogged down. You are a lawyer. Let's understand—
>
> A. What I am saying to this Commission is trying to arrive at the truth here as to what is a fair and reasonable rate of return. I am suggesting to this Commission that if it can be done in the light of their understanding and their responsibility without delay-

ing this case, without any further opening the record, that they should adopt a June 30 test year. I am suggesting precisely that, *but I am suggesting that, however, if it requires a reopening of the record to lay in a case, that they don't do that.* Rather, grant an additional attrition allowance to take into account June 30 figures. [Emphasis supplied.] [5]

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[5] Our dissenting colleagues brush aside the foregoing testimony of the Company's Vice President for Finance and its President by suggesting that one of the principal ways the majority justifies its disposition of the case is "by utilizing out of context a few selected phrases uttered during the hearing by Pepco representatives—as to whether the test year should have ended on December 31, 1974, or June 30, 1975."

In the accompanying footnote the dissent, which was authored by the minority here, states, "To complete the picture of what was said on the subject, see *Pepco I*, 380 A.2d at 140, 141 . . . and 166, 167." We note, however, that the picture there portrayed omitted the foregoing testimony of President Thompson.

While the Commission did use average 1974 figures for CWIP and M&S, as well as 1974 data for PJM Interchange sales, the Commission for the most part used an "end-of-period" rate base for 1974 to account for attrition (*see* subheading "Attrition" *infra*). The record shows that in making these determinations, the Commission did not ignore the available figures for the first six months of 1975. There is substantial evidence of record supporting the Commission's position on each of these rate base components and, taken together, the Commission's findings lead rationally to its order. This case, therefore, is unlike *Washington Public Interest Organization v. PSC*, D.C.App., 393 A.2d 71 (1978), in which the Commission had not yet satisfied the substantial evidence test because it had not satisfactorily explained the rational connection between the Uniform System of Accounts (specifically, allocation of capital gains on land to the shareholders) and the rate making result.

His final position then seems to be clear that the Company was not insisting on a change in the test year, but was urging the Commission in using a 1974 test year to consider that data in light of the more recent June 30 figures. Since the case was filed and tried by all parties on a 1974 test year, it is apparent from the foregoing that President Thompson was necessarily leaving to the discretion of the Commission the decision as to how much weight to give the new data. Mr. Thompson concluded his testimony by saying:

> I would urge upon this Commission the urgent necessity for prompt action on the case after it is completed, with the same alacrity with which you have conducted the hearings, Madam Chairperson.

When the hearing was terminated there was no question on the record that 1974 was still the test year. Although the Company believed the Commission should give thorough consideration to the updated figures, any further delay to explore the new data was not acceptable. Accordingly, respondent and intervenors, not having had time to obtain in depth familiarity with the new data, did not cross-examine Mr. Davis in detail on the new information nor did they recall their witnesses to testify regarding their analysis of the updated 1975 figures as would have been their right had the Commission announced that it was adopting a new test year. The testimony of all witnesses of the respondent and of all witnesses for the intervenors had dealt only with the 1974 calendar year data. That is what the first 2,600 pages out of a total of 2,900 pages of testimony were all about. When wholly new data are furnished at the end of a case, procedural due process as well as basic considerations of fairness require an opportunity for all parties to ex-

amine the new data, to cross-examine the utility's witnesses regarding it and to offer such evidence in surrebuttal as necessary.

In view of the testimony of the Company's own officers, it is surprising it would claim subsequently on petition to the Commission for reconsideration and on appeal here that the use of June 30, 1975 as a test year was an issue in the case.

Although the Company is expected to base its application on a specified test year, when a dispute arises later as did here, it is up to the Commission in the reasonable exercise of its discretion to determine to what extent the new data can and should be used. In this case the Commission and intervenors had good reason to conclude from the express words of Company witnesses and the apparent acquiescence of Company counsel in the position they articulated, that the Company was not insisting that a new test year be established. Counsel asserted no new position and made no motions for the adoption of a new test year. Later in oral argument to the Commission Pepco did not raise any question about a June 30, 1975 test year. Instead its lawyers appeared to assume that a 1974 test year was to be used. Company counsel, Carl D. Hobelman, said, for example:

> Now what solutions to the attrition problem exist?
>
> The one that's traditionally been used by this Commission and most others is year-end rate base, and we think that if this Commission is going to stick with the 1974 test period that that's a minimum.

Edward A. Caine, the other Pepco counsel who argued, flatly stated, while discussing the possible effect of Company land transactions, "[t]he test period in this case is

1974." The case having been filed and tried on a 1974 test year up to almost the last day, the Commission had ample basis to support the exercise of its discretion to use a 1974 test year, utilizing the 1975 updated figures as it deemed appropriate.

The Supreme Court of Arkansas has had occasion to address a strikingly similar situation. In *Arkansas Power & Light Co. v. Arkansas Public Service Commission*, 289 S.W.2d 668, 673 (Ark. 1956), where the Commission refused to consider information submitted as to post-test year data, the court held:

> As to the testing period, it clearly appears to us from the record that the appellant, itself, in its rate application chose the testing period, and the Commission accepted appellant's choice. Appellant's application was tried throughout on the theory that the test period should be the 12 months ending March 31, 1954. In other words, March 31 was to be the cut-off period of this pattern year.

We find this reasoning to be persuasive and hold there was no error in the Commission's decision not to make a last minute change in the test year. *See also New England Power Co. v. Federal Power Commission*, No. 75-1379 (unpublished) (1st Cir., Nov. 13, 1975).

We would also observe, however, that the Company's request that we reverse the Commission's decision on this issue and remand for a revision of rates upward based on 1975 data is complicated somewhat by the fact that after the Commission released its order in the instant case, Pepco promptly filed a new application with the PSC on December 29, 1975, seeking a further rate increase based on a 1975 test year. That application resulted in Order No. 5849 of December 16, 1976, granting Pepco

an increase in revenues of $29.4 million based on the 1975 data. That order has superseded the order under review here (Order No. 5739) and the Company is presently operating under the December 1976 order.[6]

The increase provided therein was awarded on the basis of the Company's operating experience for the calendar year 1975 and its financial condition as reflected by its books as of December 31, 1975. A remand now for the granting of a substantial increase to the Company's net earnings based on the first six months of 1975, as ordered by the division,[7] would cause a material change in the Company's balance sheet as of December 31, 1975. That is to say that the financial data would no longer be valid that were used to support the 1976 rate increase. The figure for 1975 net earnings might have been as much as $20 million less than the corrected figure. Should such a windfall go to the shareholders or be rebated to the 1976 ratepayers who paid an increased rate that turned out to provide the Company with greater revenues than were intended by the 1976 order? Surely the PSC would not have granted the full $29 million increase in December 1976 had it known this court was later to award the Company a substantial increase in 1975 earnings possibly up to $20 million.

A reversal and remand of the December 1975 order to the PSC at this juncture would confront the Commission and the parties with the problem of how to increase

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[6] We note that while the December 1975 application was pending, the PSC denied an interim rate increase to the Company and the Company's petition to this court for review (appeal No. 10909) was dismissed by this court on March 10, 1979.

[7] *See Potomac Elec. Power Co. v. Public Serv. Comm'n, supra*, 380 A.2d at 147. The increase would be realized by a surcharge on present customers. *Id.* at 148.

that rate in light of data for the first half of 1975 when the Commission has already put into effect a new rate based on figures for the full 1975 test year. Such a reconsideration on remand of a revised test period that overlaps a subsequent rate order cannot be compared to the Commission using the last part of the previous test period in making a new rate that will operate prospectively. For example, the PSC might want to consider a rate increase after only six months had passed since the last order but desire to base its determination on the full previous year. In that case the PSC of course would take into consideration the previous treatment of the overlapping period and no change would have occurred in those figures. The PSC would have the full picture before it in the subsequent proceeding. Here, however, the latter order which set rates in 1976 has already been finalized and there is no opportunity to take into consideration the revised financial data for 1975. Using overlapping periods for prospective ratemaking poses no problem. But in this case the division would have the PSC enlarge an old test period thereby changing the financial picture for the Company affecting a test period upon which an intervening rate increase has long since been finalized.

In respect to the effect on a remand by the intervening filing of a new application for another rate increase, the circuit has said:

> These matters having been disposed of by this opinion insofar as it is possible now to do so, very little will be left which could be remanded to the Commission, especially as any possible remaining issues are also restricted by a new application of the Company to the Commission for a rate increase, filed since argument of these appeals, and of which we take judicial notice.

> *Remand to the Commission, in the circumstances of this case, could not be to enable a rate order to be superimposed upon the old application*, filed July 14, 1949. [*Washington Gas Light Co. v. Baker*, 90 U.S.App.D.C. 98, 104, 195 F.2d 29, 35 (1951) (emphasis added).]

In *Baker* the company had filed an overlapping application whereas here the PSC has already issued an order on a subsequent application.

We are not saying that the 1976 rate order based on a calendar-1975 test year necessarily precludes equitable relief with respect to the previous rate order based on a somewhat earlier, though overlapping, test year (*i.e.*, one extending several months into 1975). We are saying, rather, that the second rate order inevitably updated, and thus to some extent corrected, the Company's rate structure, thereby reducing any claim to equitable relief. The Company's position on appeal does not take account of this 1976 adjustment; however, in view of our disposition affirming the Commission's order, we need not further consider how the second rate order might bear on the one at issue.

The question, however, of mootness is not so clear. Pepco seeks an opportunity to be made whole for the revenues it claims it lost during the period this order was effective, from December 13, 1975, to the effective date of the order of December 16, 1976, by reason of the asserted arbitrary decision of the Commission. Pepco, as well as the majority opinion of the division, suggested that this could be accomplished, if need be, by imposing a surcharge on present customers. Fortunately, as already indicated, we need not reach the complicated problem of equitable relief in light of our disposition of the case. In any event, the Company's sole remedy to seek relief was

by appealing the questioned order, which issue we now have before us. Since we view that part of the case as being a contested issue, we deny the motion of the PSC to dismiss this proceeding as moot.

ATTRITION

"Attrition 'describe[s] the tendency of the rate of return to diminish in a period of comparatively high construction costs. . . . As the high cost plant comes into service, it tends to increase the applicable rate base [investment] at a *more rapid pace* than the resultant earnings [net operating revenues], and the rate of return decreases accordingly.'" *Telephone Users Association v. Public Service Commission*, *supra* at 298, *quoting New England Telephone & Telegraph Co. v. Department of Public Utilities*, 121 N.E.2d 896, 906 (Mass. 1954).[8]

The Company contends that the Commission's failure to adjust the test year figures for continuing attrition was arbitrary, capricious and unreasonable as a matter of law. Contrary to the Company's contention, it is patently clear that the Commission did not fail to account for attrition. The final order of the Commission is replete with comments that demonstrate its concern for the problem and the consideration it gave to the evidence of attrition. We note that the Commission found in its order at pages 24 and 25:

> In short, we are persuaded that attrition is a phenomenon that is still with us, and we will therefore now, as we have in the past, use an end of period rate base, with appropriate adjustments, in order to compensate for the presence of attrition.

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[8] For additional definitions of attrition *see Telephone Users Ass'n v. Public Service Comm'n*, *supra* at 298 n.11.

In determining a fair return for the Company in terms of dollars per annum, a regulatory commission determines what a fair rate of return would be and then applies that percentage rate to a so-called rate base. Ordinarily the average rate base of the utility for the test period is used. *Telephone Users Association v. Public Service Commission*, *supra* at 298. However, in order to combat the effects of attrition, we have recognized an exception to the general rule so that when attrition is found to exist the commission may use a company's year-end rather than year's average rate base. *Id.; City of Lynchburg v. Chesapeake & Potomac Telephone Co.*, 107 S.E.2d 462, 469 (Va. 1959). This is what occurred in the instant case with certain limited exceptions. The PSC found that attrition existed and accordingly chose to follow this court's suggestion in the *Telephone Users* case and, by and large, used an end-of-year rate base.

Rate Base

The value attributed to the Company's plant in service constitutes the largest component of a utility's rate base. The next largest component is the construction work in progress (CWIP) which includes the cost of expansion projects prior to their completion at which time their value is transferred to the plant in service account. Also of importance is the Company's investment in materials and supplies (M&S).

Specifically, the Company alleges that the Commission erred in (1) including only Pepco's 1974 *average* investment in construction work in progress in the rate base; (2) including only Pepco's 1974 *average* investment in materials and supplies; and (3) including too large an amount of net Pennsylvania, New Jersey and Maryland Interchange (PJM) sales (*see infra*) as an element of operating income. However, in exercising its ratemaking

responsibility, the Commission is not bound to use any particular methodology, nor is it bound to adopt any particular alternative proposed. *Goodman v. Public Service Commission*, 162 U.S.App.D.C. 74, 82, 497 F.2d 661, 669 (1974).

In *Goodman* the circuit held that:

> In its ultimate determination of future revenue requirements, the Commission had a choice of two figures: 1) the average values applying throughout the test-year ("weighted" rate base); or 2) the values on the last day of the test-year ("end-of-period" rate base). [*Id.* at 82, 497 F.2d at 669.]

Assets committed to construction work in progress by their nature provide no service to the public or income to the Company. They are included in the rate base in this jurisdiction to provide a return to the investor for that part of his funds which are currently tied up in nonproductive plants. As those plants are completed and move out of CWIP into plant in service, they become revenue producing.[9]

The Commission's staff witness testified that the flow of dollars into CWIP increased very substantially from $187,000,000 on January 1, 1974, to $359,000,000 at year's end.[10]

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[9] As did Chalk Point III in May 1975, although figures were not available as to its revenue productivity.

[10] Since Pepco operates in Maryland and Virginia as well as the District of Columbia, only those percentages of Company figures properly allocated to the District of Columbia operation are used in computing the rate base for the District. For example, the figure for District of Columbia plant in service is computed by taking 44.82% of the total plant in service. Consequently, the Company originally arrived at a

People's Counsel, citing examples where only 60% of CWIP was used in some jurisdictions, recommended that the Commission adopt the rule followed in others that allow CWIP only up to 10% of the useful plant value. (People's Counsel Exhibit C, at 38.) The League of Women Voters asked the Commission to return to its former policy, still followed by many regulatory bodies, of excluding CWIP altogether from the rate base (brief at 6).

In view of the unusually high year-end figures, the General Services Administration urged the Commission to use a weighted average figure for CWIP, as did the Commission staff. It argued that the high year-end figure should be adjusted to normalize it to reflect conditions that may reasonably be expected to be experienced during the period the rates will be in effect.

After noting there were wide fluctuations in both the amounts of CWIP and M&S, the PSC found that: "The amounts at the end of the period in both accounts appear to be abnormally high. In view of Pepco's projected re-

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figure of $657,634,000 or 44.82% of the total plant of $1,467,207,000.

Likewise, in computing CWIP only that part of the total figure attributable to the District of Columbia operation is used. Of the total of $377,508,000 claimed originally by the Company, it allotted only $155,863,000 in its computation of the District of Columbia rate base or 41.29%. Pepco Exhibits 9, W 29 and W 30.

The staff used the same percentage figure for plant in service but allocated only 36.69% of total CWIP to the District of Columbia. *See* Staff Exhibit 4 SM-2, Sch. A p.1. On the other hand, the staff allocated 53.64% to the District of Columbia operation for plant held for future use. *Id.* The lower figure for CWIP may result from the fact that Chalk Point III, then under construction, is located in Aquasco, Maryland. Pepco Exhibit 8, at 2-3.

duction in its construction program and the reduction in fuel inventory in 1975, we do not believe that the end period figures can be called representative of anticipated future conditions." (Public Service Commission Order No. 5739 at 26.)[11] Projections of future CWIP for the period 1975 through 1977 indicated year-end averages for those years of only $288,000,000, which is quite close to the $284,000,000 1974 average figure recommended by the Commission staff. Consequently, if a year-end CWIP figure were used (which was not likely to be representative of future CWIP levels) a skewed rate base would result.[12] The Commission found that this could not be justified and thus decided that it would use an average rather than year-end CWIP figure. We find this conclusion to be supported by substantial evidence and accordingly the PSC's judgment on the matter will not be disturbed. *Telephone Users Association v. Public Service Commission, supra.*

In a similar vein, Pepco challenges the inclusion of only an average rather than an end of the 1974 year figure in the rate base for investment in materials and supplies. The Commission decided to use an average figure for 1974 ($66,296,000) rather than the larger year-end amount ($88,073,000). We conclude that the evidence produced before the PSC supported this result.

The Commission heard testimony that the year-end figure was a consequence of an historic but passing instability in the fuel market. Pepco, like other companies,

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[11] The figures for a test year are not binding on the Commission except to the extent it concludes they may be considered representative of the future.

[12] Given a certain desired rate of return, the larger the rate base of the utility the greater will be its revenue requirement. *Telephone Users Ass'n v. Public Service Comm'n, supra* at 298.

had increased its fuel inventories substantially during 1974 because of abnormal conditions suggesting a forthcoming fuel shortage. The scarcity that developed caused fuel supplies to be stockpiled to assure adequate supplies during the energy crisis. The staff review of the Company's previous three years indicated large month-to-month fluctuations in inventory balances. In addition there was testimony that the average levels in those years were more representative of normal conditions. The use of the weighted year average recognized a return to stability in the market. As the New Jersey Supreme Court stated in *Atlantic City Sewerage Co. v. Board of Public Utilities Commission*, 26 A.2d 71, 76 (Sup. Ct. 1942), *aff'd*, 29 A.2d 850 (N.J. Ct. Err. & App. 1942):

> Abnormally high prices for . . . material attendant upon an unstable market do not afford a just criterion of the value of property for rate purposes.

We find that as with CWIP, there was substantial evidence justifying the Commission's finding that year-end amounts in the materials and supplies account were unusually high and that an average computation would be more reflective of future conditions. Accordingly, we affirm the Commission on this issue.

Pepco's final claim of error is that the Commission's failure to adjust its 1974 test period to reflect a change in the Company's receipts from Interchange sales to other utilities was arbitrary, capricious and unreasonable as a matter of law. It accordingly urges that the PSC's decision be reversed and remanded for further action.

This issue involves the PJM (Pennsylvania, New Jersey, Maryland) Interchange, an energy pool of approximately twelve power companies established to enhance overall reliability of service and economy of

generation within the Interchange area. Member companies of this pool make sales of energy to each other from currently available excess capacity. The price of such transactions is midway between the incremental cost (essentially fuel cost) to the seller and the incremental cost to the buyer, had it generated the electricity purchased. The seller's cost is always lower or no sale is made. Thus the seller realizes a profit as measured by the difference between its incremental cost and the midpoint, and the purchaser receives electricity at a price cheaper than that at which it could have generated the electricity at the time. Over the course of a year, Pepco both sells and purchases electricity on the Interchange. However, historically it has been a net seller, and was in fact a net seller during 1974. The PSC observed in its order that there had been "a substantial decrease in the energy and capacity sold by Pepco to" the PJM Pool. Later in the order it found that "sales to PJM appear to have leveled off to a large degree."

Pepco's Interchange activities have an impact on its investors and customers. In periods between rate cases, investors bear the risk of profit and loss from such transactions. However, for ratemaking purposes, the profits realized during the test year are set off against operating expenses incurred in providing service to its customers locally. Thus recorded operating expenses for ratemaking purposes are reduced by the amount of the offset of Interchange profits to the benefit of the customers.

By their nature, Interchange activities are volatile and unpredictable. The Company admits that it has little control over the ultimate dollar value of the Interchange credits and equally little ability to predict with any degree of certainty the dollar value of such credits except over very short periods of time. However, it appears from the record that with the increasing consumer aware-

ness of conservation of electrical power, PJM sales were declining and there was evidence to show they will continue to decline, but at a rate which cannot be precisely determined. With this basic unpredictability, it is, of course, quite difficult for the Commission to establish a figure which will accurately reflect the PJM Interchange sales for the future. However, to approximate the future sales, the Commission decided to use the test year data. Thus it used the 1974 data for calculating the net sales for PJM transactions and arrived at a figure of $46,532,000 as the amount allocable to its operations in the District of Columbia.

Pepco asserts, however, that while the PSC was considering its decision, the amount of Interchange sales continued to decline—to $32,605,000 for the 12 months ending June 30, 1975 and to $28,133,000 for the 12 months ending August 31, 1975. The Company argues that the failure of the Commission to take these figures into account was arbitrary and capricious.

We cannot say that the Commission's decision to be guided by figures for the 1974 test year constitutes reversible error. This portion of the Commission's order, like any other, must be read in context. It appears the Commission was well aware of the point made by the Company and did not ignore it. In its Final Opinion and Order the Commission said:

> The latter part of 1974, however, witnessed a sharp and steady decline in the PEPCO financial results. Viewing the record as a whole, two factors stand out as perhaps the principal causes of this decline: (1) energy conservation resulted in a substantial decrease in the number of kilowatt hours sold at retail by PEPCO in 1974; and (2) a substantial decrease in the

> energy and capacity sold by PEPCO to the Pennsylvania, New Jersey, Maryand (PJM) Pool, of which PEPCO is a member. Had these two dramatic changes not occurred, the need for a rate increase application by PEPCO may very well have been eliminated. Together, the two changes represented an order of magnitude decrease in PEPCO's gross revenue of some $65,000,000.
>
> We see no evidence of record which persuades us that there will be a return to past normalcy in the near future in either or both of these items. Although 1975 operating data, of which we may take official notice, indicates a resumption of a growth trend in retail kilowatt hour sales, it appears that the over 60% reduction in PJM sales is continuing and thus the two factors tend to offset each other to some degree. Thus, while 1974 was indeed an unusual year for PEPCO when compared to the 1970-1973 period, the record indicates that 1974 level conditions, rather than those prevailing in 1973, are more representative of conditions reasonably expected to exist in the future.
>
> A look at the future, therefore, indicates a new and different "normalcy" on which our predictions of things to come may properly be based. With that base, we believe that adherence to traditional regulatory concepts will give reasonable assurance of achieving the desired end result. We shall therefore follow that course here . . . . [*Id.* at 6-7.]

Later the Commission observed:

> We are not persuaded, however, that the decline in earnings has been due solely to attrition, but

> has in large part been due to the drop in sales noted previously. Since sales to retail customers appear to have resumed a somewhat normal growth pattern, and since sales to PJM appear to have leveled off to a large degree, and since PEPCO has substantially reduced its construction budget, it appears reasonable to conclude that attrition in the future may play a less significant role than it has in the past. [*Id.* at 25.]

We are mindful of the volatile nature of Interchange sales and their unpredictability and the fact that the Commission has already given consideration to that problem. The Commission's reasoning is not without logic and gives no indication of being arbitrary. Further, there is evidence in the record to support its findings and conclusions in this regard. Accordingly we hold the Commission's action was not arbitrary, capricious and unreasonable as a matter of law and we will not substitute our judgment for that of the Commission.

There being no other issues raised and "the findings of fact by the Commission [being] conclusive unless it shall appear that such findings of the Commission are unreasonable, arbitrary or capricious" (D.C. Code 1973, § 43-706) and finding no reversible error of law, the appeal is dismissed and the decision of the Commission is

Affirmed.[13]

[13] The unfortunate tone of the dissent speaks for itself and dispels any need for rebuttal comment on the issues.

HARRIS, *Associate Judge*, with whom *Associate Judge* NEBEKER concurs, dissenting: This is the first major public utility rate case to be handled by this court (as a consequence of the Court Reform and Criminal Procedure Act of 1970, *see* D.C. Code 1973, § 43-705). Because of that fact, in writing the original majority opinion for the division, particular care was taken to describe the applicable legal principles and to spell out in detail the errors in the Commission's disposition of the case. *Potomac Electric Power Co. v. PSC*, D.C.App., 380 A.2d 126 (1977) (hereinafter cited as *Pepco I*). With all due respect for my esteemed colleague, Judge YEAGLEY's then-dissenting opinion did not reflect a recognition of certain basic characteristics of ratemaking proceedings. *See Pepco I*, at 150-62. The deficiencies in Judge YEAGLEY's dissent were cogently addressed by Judge NEBEKER in his concurring opinion. *See Pepco I*, at 164-69.

It would be difficult for me to conceive of a rate case in which the agency's action could more readily be seen to be erroneous than this case. *See* D.C. Code 1973, § 43-706. One result of the majority's resolution of this appeal seems regrettably inescapable: The Commission will conclude that virtually any treatment of a utility which purports to be "pro-consumer" in nature is likely to escape perceptive judicial review.[1]

[1] The majority's "hear no evil, see no evil" approach to this case is wholly inconsistent with the 2-1 decision of another division of this court in *Washington Public Interest Organization v. PSC*, D.C.App., 393 A.2d 71 (1978). There the majority reached the following conclusion:

> Given the presumptive validity of the Commission's expert judgment in balancing investor and consumer interests, taken against petitioners' own incomplete analysis, we must conclude that petitioners have not made the

The temptation is strong to challenge item-by-item the many flaws in the majority opinion. Such an exercise is not necessary, however, since there are three existing well-documented opinions which address the issues at length. The first is the opinion of Commissioner Stratton written in dissent to the Commission's decision. *In re Potomac Electric Power Co.*, 11 P.U.R.4th 215, 237-51 (PSC D.C. 1975). The second and third, as noted above, are the majority and concurring opinions in *Pepco I* which the majority has chosen to overturn. I would, however, now make a few comments, supplemented by a number of references to portions of Commissioner Stratton's dissent which were not referred to in my earlier opinion for the division majority.

The Commission decided upon an overall 9.1 percent rate of return for Pepco. That conclusion prompted the following statement by Commissioner Stratton:

> It cannot be demonstrated that the rate of return found reasonable by the commission fails the statutory test [of establishing "just and reasonable" rates], and I support it even though it is in the low range . . . . [11 P.U.R.4th at 251.]

Establishing a rate of return, however, is but a starting step in determining a utility's revenue needs. Commissioner Stratton aptly inquired: "Thus did the right

"convincing showing" required to overturn a rate order. They cannot prevail at this time. [*Id.*, at 89.]

That, of course, should have been the end of the matter; the Commission's action should have been affirmed and the appeal dismissed. *See* D.C. Code 1973, § 43-705. However, based upon a dissatisfaction with the Commission's reliance on its established Uniform System of Accounts, the court remanded the case for further exposition by the Commission. (Judge NEBEKER and I voted to grant the petitions for rehearing en banc which were filed in that case.)

hand give but what of the left hand?" *Id.*, at 240. What the left hand did, to complete the metaphor, was take away. To reduce the case to its essence, the Commission impermissibly (1) tore tens of millions of dollars out of Pepco's rate base, and (2) overstated revenue expectations from projected sales of excess generating capacity by Pepco to the PJM interchange.[2] The obvious explanation for such action, as expressed by Commissioner Stratton (with particular reference to the grossly unwarranted reduction of the rate base item of construction work in progress), is that it constituted "an expediency perpetrated in the interest of holding down rates [which] must be seen as arbitrary and is, on that basis, probably reversible error." *Id.*, at 244.

I quote Commissioner Stratton's evaluation of what basically was at stake before the Commission:

> The real issue in this case is whether this commission can so demonstrate its understanding of this utility and the world in which it must exist as to issue a rate order under which the utility can operate for a reasonable period of time without returning to us in quest of higher rates. This we have failed to do. Our failure is rooted in our denial of known and inexorable upward pressures on operating and capital costs, with which revenues must keep pace if a utility is to fulfill its service obligation. [11 P.U.R. 4th at 238.]

[2] In its treatment of the PJM interchange issue, the majority recites some of the facts which reflect significant decreases in Pepco's revenues therefrom, but ultimately simply retreats into the "we will not substitute our judgment for that of the Commission" refuge. *Ante*, at 28. I readily recognize that we are not to substitute our judgment for that of the agency, but the Commission's actions here far transcend the rather broad area of mere judgmental differences.

The en banc court's majority opinion reflects an inadequate understanding of how rate cases routinely are tried. When a rate increase application is filed, typically a test year is adopted which includes a majority of past months with actual operating results (here, eight months) and a smaller number of months (here, four months) for which data are predicted. Then, as the hearing proceeds, actual data are substituted for the prior estimates. This is done quite simply, but the majority seems to see problems in such a routine substitution of numbers.[3] I agree with Commissioner Stratton's axiomatic comments on the use of a test year:

> [O]ne must recognize that the test-year approach to rate making is a forecasting methodology, as it must be, since rates are made for the future. The test-year approach [is] implemented as follows: a recent 12-month period (calendar 1974 in this case) is selected as the test year; financial results of that year's operations are used as the base data in the analytical process; [and] known changes are reflected as pro forma adjustments to the test-year operating results . . . . [11 P.U.R.4th at 238.]
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> * * * *
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> [T]he test-year device is imperfect, but, like democracy, it is probably better than the alternatives. This imperfection is compensated for in some measure by adjusting test-year data in order that it better mirror the future, typically

[3] Regulated utilities follow the Commission's Uniform System of Accounts, and Commission personnel regularly monitor the company's books. Thus, for example, if Pepco predicts that its fuel expense for the forthcoming month of June will be x dollars, it is exceptionally easy later to substitute the amount of money actually spent.

> by taking into account known changes that are not fully reflected in test-year data . . . . [*Id.*, at 239.]

It must be borne in mind that the administrative process in this case was protracted, in part because of the delay occasioned by the establishment of the office of People's Counsel. Pepco's application was filed on December 20, 1974. The hearing began on June 4, 1975; it did not end until July 25, 1975. By that time, complete operating figures through June 30, 1975, had been introduced into evidence. Data for July and August of 1975 later were provided by the company, and oral argument was conducted on September 30, 1975.

Often in rate cases, a commission is required to exercise its discretion in determining which of the competing parties' projections are more valid. That was not true here; to return to Commissioner Stratton's analysis:

> But the commission was not compelled to select between the conjecture of the company and the conjecture of the staff. We have accepted into the record monthly operating statements and balance sheets for the first eight months of 1975, and these were available to us as we deliberated upon this case. I had thought our purpose in accepting current financial reports was to permit us to make a better informed decision. Are we free to decline the opportunity to do so? I think not. [*Id.*, at 241.]

There is an interesting passage in the en banc court's majority opinion. The majority recognizes that:

> [T]he most recent available material must be considered and weighed by the Commission in reaching decisions on ratemaking. This is con-

> sistent with effective ratemaking policy. If recent operating figures are completely ignored, the new rate will be based on old and perhaps no longer valid data. [*Ante*, at 9.]

How the majority could acknowledge those truths and still fail to see the errors in the Commission's actions defies comprehension. The original opinion for the division majority sets forth in detail the Commission's distorted treatment of the rate base items of both materials and supplies and construction work in progress (CWIP), and of the revenue item relating to PJM interchange sales. 380 A.2d at 145-47. I shall not restate those points here, but a brief description of what the Commission did with respect to one component of CWIP warrants inclusion in this dissent.

The funds expended by the utility for CWIP consistently have been included in its rate base. During all of 1974, a new generating plant—Chalk Point Unit No. 3—was under construction. There was no question as to the dollar amounts expended on that project. In May of 1975, months before the record was closed, the new plant was placed in operation, and the roughly $160 million which it cost were transferred from the company's CWIP account to the plant in service account. These facts were routine and unchallenged, and any objective observer would have deemed it inconceivable for the Commission to fail to include that $160 million in the company's overall rate base (with the appropriate percentage thereof going into Pepco's District of Columbia rate base). In what must surely have been one of the most arbitrary actions in the history of American ratemaking, however, the Commission refused to include the completed Chalk Point Unit No. 3 in the rate base. Moreover, although in the 1970 and 1973 decisions in prior Pepco rate cases

the Commission properly sought to compensate for attrition by using a year-end computation of CWIP, here it further eroded the rate base by taking a 1974 average CWIP figure.

The overall effect of the several devices thus arbitrarily and unreasonably utilized by the Commission was to reduce the company's District of Columbia rate base to $650,091,000 [*see* 11 P.U.R.4th at 228], and to understate the company's revenue needs by exaggerating the net receipts supposedly anticipated from PJM sales. In the final paragraph of his dissent, Commissioner Stratton stated: "At a minimum, the rate base should have been established at $693 million . . . ." *Id.*, at 251. I share that conclusion.

The majority seeks to justify its disposition of this case in two principal ways. The first is an artificial semantic exercise—performed by utilizing out of context a few selected phrases uttered during the hearing by Pepco representatives—as to whether the test year should have ended December 31, 1974, or June 30, 1975.[4] Not only is the majority's treatment of that question illogical (there is no doubt on this record but that Pepco—quite understandably in this period of severe inflation and rampant fuel cost increases—wanted to use its most current actual operating data); it also is largely irrelevant. As I have noted, the en banc majority recognizes the obligation of the Commission to use current data; as long as such figures are used it matters little whether we say that the test year should have ended June 30, 1975 (as

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[4] The en banc court's majority opinion—like Judge YEAGLEY's earlier dissent—is unduly selective in its excerpting of the relevant remarks from the record. To complete the picture of what was said on the subject, *see Pepco I*, 380 A.2d at 140-41 (majority opinion) and 166-67 (NEBEKER, J., concurring).

did the original majority opinion for the division), or that the Commission was obliged to adjust the test year data to reflect known later facts of record. Considered properly, the record simply reflects Pepco's related anxieties to avoid further delays and achieve prompt rate relief.

The second way in which the majority supports its result is by (1) making cursory references to Pepco's contentions on appeal, followed by (2) stating with respect to each contention that the Commission considered the subject, hence effectively ending the matter.[5] Such an approach, however, begs the issue. It is beyond question that the Commission considered what it was doing; its rulings were calculated, not accidental. It determined that Pepco theoretically should have the opportunity to earn an overall 9.1 percent rate of return, but then by the devices discussed above—such as erroneously reducing the company's District of Columbia rate base by some $43 million, to accept Commissioner Stratton's figure—it made it a certainty that such a rate of return could not be achieved. (An erroneous diminution of rate base correspondingly erroneously reduces revenues, for revenues are mathematically linked to rate base.)

A third factor militating towards affirmance appears in the en banc majority opinion, although the extent of its effect is difficult to ascertain. The majority devotes several pages of its opinion to expressing concern as to the complications which would be presented if we were to reverse. *Ante*, at 15-18. Such an approach is grievously

[5] In the *Washington Public Interest Organization* case which I cited in footnote 1, *supra*, the majority of that division recognized the risk that a "non-expert" court "could simply be fooled into accepting arbitrary agency action by the mesmerizing influence of the confidently expressed language of experts." 393 A.2d at 78. Regrettably, that concern has become a reality in this case.

unfair to Pepco as a party in this court; it is entitled to have its case determined exclusively "upon the record" on appeal (D.C. Code 1973, § 43-705), and a consideration of the potential consequences of a reversal is irrelevant to the requisite basic analysis as to whether the Commission's decision is to be affirmed or reversed—exclusively on its merits."

In turning to an overview of this case, one maxim must be recognized: A regulatory commission which is unduly pro-consumer inevitably must be recognized to be anti-consumer as well. To jeopardize a utility's economic stability is simultaneously to jeopardize its ability to provide the service upon which its customers so vitally depend (as well, incidentally, as to increase its costs of obtaining capital, which costs in the long run must be borne by the ratepayers). The Commission does not have a partisan role; it has both a statutory and a constitutional obligation to set just and reasonable rates, *i.e.*, rates which permit a utility the opportunity to earn a fair rate of return on its investment. *See Pepco I*, *supra*, 380 A.2d at 131-32 and cases there cited. If the Commission arbitrarily refuses to achieve the requisite delicate balance between consumer and investor interests, it is not only violating the utility's constitutional rights, it

[6] In his prior dissent to the majority opinion of the division, Judge YEAGLEY took the position that his view of the case was demonstrably correct since the market price of Pepco's stock had risen subsequent to the Commission's decision. *Pepco I*, 380 A.2d at 159-60. Such an analysis was both faulty and unwarranted, as noted by Judge NEBEKER in his concurring opinion. *Id.*, at 168-69. I note with some relief that the notion that stock prices are indicative of whether an agency's ruling is proper or erroneous has had at least no visible effect upon the en banc majority's disposition of the case.

is harming the true long-range interests of consumers as well. *Ibid.* That is precisely what occurred in this case.

Commissioner Stratton's dissatisfaction with his agency's disposition of this case was such that he was moved to express the following beliefs:

> To sum up, the commission's order posits an economic environment reminiscent of the early 1960's. In failing to acknowledge and deal with the fact that operating and capital requirements per unit of sales have risen, and continue to rise, faster than revenues the commission has taken a step that can only bring regulation in the District of Columbia into disrepute among the fair-minded and knowledgeable. [11 P.U.R. 4th at 251.]

I feel comparable consternation at my colleagues' superficial approach to their review of the Commission's actions. In my view, the majority's failure to recognize the realities of this case is analytically indefensible. Accordingly, I respectfully dissent.